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LAW AND CONTEMPORARY PROBLEMS

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FOREWORD

The widely-shared determination that the intense economic activity necessitated by war should not afford an opportunity for the reaping of extraordinary profits has made possible the enactment of a series of measures designed to keep wartime gains within reasonable bounds. Most conspicuous among these is the excess profits tax, which, in its present form, constitutes one of the most drastic levies ever imposed by an American government.

The huge sums of money exacted by this tax have required that the law imposing it be framed with meticulous care. As a result, the present act, which represents the third effort by the Congress and its Treasury advisers, is one of the most complex mechanisms ever to be incorporated in our already complex tax system.

The exposition of the principal provisions of this tax is the function of the first four articles in the symposium. The first of these traces the development of the tax law's structure and outlines its present form. The second article seeks to distill from the legislative provisions the essential concept of excess profits. A subject of intense practical importance—the grounds for "relief" to the taxpayer who claims abnormal experience in the base period—is considered fully in the third article. The last article in this group examines comprehensively the multifarious problems which spring from the impact of the tax on corporations that have passed through mergers or consolidations. A succeeding article depicts the difficulties which application of the statutory standards entail for the accountant who must provide the requisite data.

The succeeding group of four articles presents a different approach to excess profits taxation. In these articles the economic and fiscal context in which the excess profits tax is set has been developed, and an appraisal essayed of the place of the tax in our present, and in any post-war, tax systems.

The two concluding articles in the symposium are not, strictly, within the ambit of the excess profits tax. However, the subjects with which they deal, the tax problems of war plant expansion and of foreign war losses, relate to adjustments in the tax laws which were dictated by war exigencies and have been rendered all the more imperative by reason of the heavy tax rates applicable to corporate incomes and excess profits.

Closely related to the excess profits tax in certain of its aspects is the procedure of the War and Navy Departments and the Maritime Commission for renego-

tiating war contracts. The legal and economic phases of renegotiation will be the subject of the succeeding symposium, to be followed in turn by a symposium on a related subject of equally vital concern to the wartime economy: the termination of war contracts.

These symposia will be published, it is hoped, during the coming winter or early spring. As has already been announced, the long, yet inescapable, delays encountered in the organization of the current issue have convinced us that the publication of two issues per year will represent all that we can assure our readers until the war's end.

We are grateful to our subscribers for the patience they have manifested throughout the many months during which this symposium was overdue. And we are grateful also for the forebearance of those contributors who submitted manuscripts last winter and who, despite our inability to assemble the symposium on schedule, allowed us to retain and publish their papers. Fortunately, only a small degree of revision was required to bring them to date.

Commencing with the next issue, my colleague, Professor E. R. Latty will edit the quarterly, a leave of absence having been granted to me for service with the Government.

DAVID F. CAVERS.

THE STATUTORY EVOLUTION OF THE EXCESS PROFITS TAX

C. Rudolf Peterson*

It is less than three years since Congress, following the example of World War I, enacted a general excess profits tax—the Excess Profits Tax Act of 1940. In the intervening period there has been one act, the Excess Profits Tax Amendments of 1941, devoted entirely to amendment of the original provisions; a second, the Revenue Act of 1941, which made further important amendments; and now recently a third, the Revenue Act of 1942, which, of its 208 pages, contains 47 on the subject of excess profits—20 more than the original Act itself. *Inter arma non silent leges.*

The 1940 Act came as a result of the greatly accelerated defense effort which was one of the consequences of the German successes in the West in the spring of that year. On May 16, the President urged upon Congress the pressing necessity for increased defense expenditures.[1] Congress responded immediately and, to assist in financing the additional appropriations, passed the Revenue Act of 1940 (to be distinguished from the Second Revenue Act of 1940, Title II of which constituted the Excess Profits Tax Act of 1940). By this Act, individual surtax rates were increased, personal exemptions were reduced, corporate rates were raised by 1%, and a defense tax of 10% of the tax otherwise computed was imposed on all taxpayers, individuals and corporations alike, for a period of five years. This Act was approved June 25th.

The administration next turned its attention to the social consequences of the greatly increased expenditures to be made by the Government for war purposes, the major problem being the extent to which taxpayers should be permitted to make money out of the national emergency. Since 1934, as an incident to the naval expansion program which began approximately at that time, there had been on the books a statute, the Vinson-Trammell Act, providing for the recapture of excessive profits on certain government contracts.[2] By 1940 this statute, which had originally been limited to contracts for the construction of naval vessels and naval aircraft, had been enlarged so that it also covered contracts for the construction of army aircraft. This type of legislation, however, was not adequate in the face of the greatly ex-

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[1] H. R. Doc. No. 751, 76th Cong., 3d Sess. (1940).

[2] §3 of the Act of March 27, 1934 (48 Stat. 505; 34 U. S. C. §496), as amended, and §2(b) of the Act of June 28, 1940. See also §505(b) of the Merchant Marine Act of 1936, as amended.

panded program for national defense upon which the country was embarking under the threat of war. On July 1, 1940, in recognition of this fact, the President addressed a communication[3] to the Congress which referred to the great national defense effort in which the country was then engaged, to which "even our humblest citizens" were being asked "to contribute their mite," and stated that it was the Government's duty to see that the burden was equitably distributed according to ability to pay so that a few should not gain from the sacrifices of the many. "The enactment of a steeply graduated excess-profits tax, to be applied to all individuals and all corporate organizations without discrimination," was therefore strongly recommended.

The enactment of an excess profits tax was immediately considered by Congress and became part of a three-point program, the other parts of which were provision for the five-year amortization of emergency facilities and suspension of the profit-limiting provisions of the Vinson-Trammell Act. The entire program was first referred for study to a subcommittee of the Committee on Ways and Means, which presented its report on August 8th. In this report the President's recommendation that the excess profits tax apply to individuals and partnerships as well as to corporations was abandoned and the proposed tax was limited to corporations only. This conclusion was reached not only because of the difficulties of devising a tax of this nature which could be applied to noncorporate taxpayers with any accuracy, but also because an additional levy was made unnecessary by the high rates of surtax applicable to individuals, coupled with the fact that there could be no avoidance of such taxes by leaving profits in the business as in the case of a corporation. There has been no serious attempt to alter this basic policy, though a number of trial balloons have recently been raised to test public reaction to a proposal to incorporate a noncorporate excess profits tax in a possible 1943 bill.

With the general issue of the scope of the tax out of the way, the subcommittee proceeded to make specific recommendations as to the precise form the tax was to take. Discussion of the details of the Act which evolved and subsequent developments will center on a few broad categories, as follows: (a) determination of excess profits, (b) rate structure, (c) relationship between the excess profits tax and the income tax, (d) computation of excess profits net income, (e) so-called relief, and (f) treatment of special types of corporations.

I. Excess Profits

(a) *General*

The major consideration in any excess profits tax system is the standard by which it is determined how much of a taxpayer's profits are excess profits.

Under the Vinson-Trammell Act,[4] with its limited scope, the measure of profits permitted to be retained was a stated percentage of the contract price. Everything in excess of such stated percentage was required to be refunded to the Government. The same method was employed in the case of contracts or subcontracts subject to

[3] H. R. Rep. No. 2894, 76th Cong., 3d Sess. (1940) 2. [4] See note 2, *supra*.

the provisions of Section 505(b) of the Merchant Marine Act of 1936, as amended. Regardless of whether such a method may be justified where the statutory restrictions apply only to certain contracts which may constitute only a part of the taxpayer's business, it was considered obviously inappropriate in a general excess profits tax act.

In determining the proper measure of excess profits, it is first necessary to decide the type of profits which the tax is intended to reach. Is the basic policy to be the regulation of profits in a manner similar to that in which the profits of a public utility are regulated, that is, is the concept to be one of unreasonable profits? Or is it intended only to tax profits to the extent they exceed peacetime profits, that is, is the concept to be one of war profits? The former would measure the excess profits credit by an assumed fair return on the capital invested in the business, the latter by normal earnings. Congress, from the beginning, solved these questions by permitting taxpayers to use whichever method was the more favorable. This has sometimes produced confusion of thought in analyzing particular cases and makes impossible any exposition of the statute along simple and direct lines, but it was thought that a double-headed system would go far toward eliminating hardships and the necessity for the vague and discretionary type of relief which characterized the World War I excess profits tax act. In this respect expectations have unfortunately not been fulfilled, but, on the contrary, a broad and far-reaching relief system has been found to be imperative if inequity is to be avoided.

At the outset, the Treasury urged the invested capital plan as the sole method for determining excess profits and, even though the Treasury was unsuccessful in having its recommendations in this respect adopted, the invested capital credit was clearly the dominant one in the early stages of the Act's development. One of the most conspicuous features of the evolution of the excess profits tax, however, has been the shift in emphasis from the invested capital credit to the average earnings credit, so that now the latter credit is clearly the primary one. The major problems of excess profits tax relief are solved in terms of an average earnings credit, hypothetical or real, and whatever liberalizing changes have been made in the credit system have on the whole been confined to the average earnings as opposed to the invested capital credit. Indeed, at one stage of the Act's development, what was in effect a penalty tax upon the use of the invested capital credit was proposed.

(b) *Development of Excess Profits Credits*

(1) *Original Proposals*

As has already been indicated, the Treasury originally favored an invested capital plan exclusively. In fact, the invested capital provisions of the House Bill in 1940 may be said to represent the Treasury's concept of an excess profits credit, the average earnings plan, which was also contained in that Bill, having been included in the face of stern resistance by the Treasury. Yet the Treasury's invested capital plan included some measure of base period experience. As such, it represented

something of a compromise, which will be fully appreciated when it is remembered that it was developed with the idea that it would constitute the sole available credit. When the average earnings credit was added and sufficient time had elapsed for an examination of the relationship between the two credits, it was seen that the need for this element had disappeared.

The Treasury plan was extremely complicated but may be briefly summarized as follows: Excess profits net income for each base period year was determined. Likewise, a computation was made of the taxpayer's invested capital covering the base period. On the basis of these figures the average rate of return for the base period was ascertained and this percentage, called base period percentage, was the basic rate of return to be allowed in computing the excess profits credit to the extent the corporation's invested capital represented a continuation of that employed during the base period. However, a floor of 7% and a ceiling of 10% were placed on the first $500,000 of invested capital and the same ceiling but a lower floor (5%) on the remainder of the corporation's invested capital. To the extent that the corporation's invested capital for the taxable year exceeded the invested capital at the close of the base period, it was considered new capital, entitled to a 10% return on so much as did not bring the total invested capital above $500,000 and 8% on the remainder. The concept of invested capital also included borrowed capital, but not at a uniform rate of 50%. Varying proportions were included, depending upon the size of the corporation.

The original Bill likewise contained an average earnings credit. It had many limitations, however. In the first place, it was available only to corporations in existence for the entire 48-month period preceding the beginning of the first excess profits tax taxable year. Although 100% of the average base period net income was allowed to be employed, the use of the credit was penalized by a rate schedule which was five percentage points higher in each bracket than that applicable when the invested capital credit was used, and by the further imposition of what was in effect an increase in the normal tax rate from 20.9% to 25%.

(2) *Development in the Senate*

When the Bill reached the Senate, changes in the invested capital credit were largely in the interest of simplification, made possible in considerable degree by the incorporation of an alternate average earnings credit. All elements of base period experience were eliminated and a flat 8% rate of return was substituted. The complicated schedule governing the inclusion of borrowed capital was likewise abolished, and, in lieu thereof, a uniform rule for the inclusion of all borrowed capital at 50% was provided. Thus, the invested capital credit was brought substantially to its present form so far as its general structure was concerned, though later changes (principally with regard to rates) have considerably altered its effect in individual cases.

The Senate likewise made changes in the average earnings credit. Some of the Senate amendments were yielded in conference, but the average earnings credit as finally enacted was less of a stepchild than it was in the House Bill. A taxpayer employing such credit was not subjected to any higher or different rates of tax than its invested capital counterpart. In return for this concession, however, the amount of average base period net income which could be employed was reduced from 100% to 95%. The availability of the credit was greatly enlarged. Corporations which were not in existence for the entire 48-month period preceding the beginning of their first excess profits tax taxable year were given the privilege of using the credit, provided they were not organized after December 31, 1939. Vacant years in the base period were given an excess profits net income equal to 8% of the taxpayer's invested capital as of the day following the close of the base period. A further liberalizing provision, which would have allowed the average to be based upon the best three out of four years in the base period, was lost in conference.

(3) *Subsequent Developments*

The most important liberalizing amendment of the average earnings credit which has been adopted since the 1940 Act is found in the Excess Profits Tax Amendments of 1941. The original average earnings credit was computed strictly on a general average basis, that is, average base period net income was merely the algebraic sum of the excess profits net incomes for the several base period years, divided by four. The only concession which was made was that a deficit in excess profits net income for one year (or the largest, if there were deficits in more than one year) could be treated as zero. The Excess Profits Tax Amendments of 1941 added an alternate method, commonly known as the "growth formula." Under this method, the average base period net income was in effect the average for the last two years of the base period plus one-half the difference between the first half average and the second half average. A number of limitations were appended to the provision to prevent war income from inflating the credit and to make certain that the average base period net income did not exceed the highest excess profits net income for any single year in the base period. But the provision was, nevertheless, a great boon to "corporations whose facilities and production capacities were substantially increased during this [the base] period," the object being to prevent such corporations from being "penalized as compared to corporations which had already achieved and maintained a high and constant level of production."[5]

The beginning of a change in emphasis from the invested capital credit to the average earnings credit is also apparent in the approach which the Excess Profits Tax Amendments of 1941 took to the question of general relief. No attempt was made to provide for curing abnormalities in invested capital, but an elaborate provision was enacted for curing abnormalities in base period net income. The possibility of substituting a constructive average base period net income for an actual

[5] H. R. REP. No. 146, 77th Cong., 1st Sess. (1941) 3.

average base period net income which was unrepresentative of the taxpayer's normal earning power obviously increased the number of cases in which the average earnings credit provided by Section 713, as opposed to the invested capital credit set forth in Section 714, could be advantageously employed.

The Revenue Act of 1941 contained no changes in the average earnings credit, but the policy reasons for retaining such a credit were emphatically reaffirmed in terms which indicate that that credit was already being thought of as the dominant one. Two changes were made in the invested capital credit, however. One reduced the rate of return on invested capital in excess of $5 million from 8 to 7%. The other made provision for giving a higher rate of return on capital invested in the business after 1940 by permitting its inclusion in invested capital at 125% rather than 100%. The net balance was a continuation of the downward curve of the invested capital credit's importance. Of considerable significance in indicating the trend were two other circumstances occurring at this time, one involving a provision which was included in the Bill at one stage,[6] but was later defeated, and the other a collateral change having a bearing on the relative effects of the two types of credits. The first was the proposal for a special 10% tax on the amount of adjusted excess profits net income which was saved from excess profits tax by the use of the invested capital credit rather than the average earnings credit. The purpose of this provision was to impose some additional tax upon war profits realized by corporations which had never had a rate of return as high as that allowed by Section 714 and were consequently insulated against a special tax on war profits by that provision. The second was the change in the relationship of the excess profits tax and the income tax, discussed under heading III. By reversing the order of deductions, so that the income tax was no longer deductible in computing the excess profits tax, a greater burden was placed on the use of the invested capital credit. Where the average earnings credit was used, the increase in current excess profits net income was at least partly offset by the elimination of the requirement that base period income be reduced by the amount of the income taxes thereon.

The average earnings credit was further expanded in the Revenue Act of 1942 by the belated inclusion of a provision half way between treating a deficit year as zero and permitting the average to be computed on the basis of three out of four years. In computing average base period net income under the general average method, the taxpayer is now permitted to raise his lowest year to an amount equal to 75% of the average for the other three years. The 1942 Act also greatly expanded the general relief provision, which will be discussed later. Even corporations not previously entitled to use the average earnings plan are now given that privilege, by being embraced within the scope of the relief provision if they can show that invested capital is an inadequate standard for determining excess profits in their

[6] See H. R. REP. No. 1040, 77th Cong., 1st Sess. (1941) 43, *et seq.*

case and can establish a constructive average base period net income which is a fair standard of normal earnings.

At the same time, further reductions were made in the rates of return permissible in the case of the invested capital credit. The original 8% return now applies only to the first $5 million of invested capital, the next $5 million being limited to a 7% return, the next $190 million to 6%, and all in excess of $200 million to 5%.

Mention has not thus far been made of the method employed by the Act for computing equity invested capital. It is commonly known as the "tax basis" rule. Equity invested capital is not the present stockholders' investment, nor is it the company's net worth at a given date, such as January 1, 1940. It is a historical figure representing the amount of money or property paid in for stock or as paid-in surplus or as a contribution to capital, plus accumulated earnings and profits, less capital distributions. Property paid in is included at its tax basis rather than its then value, which operates as a limitation upon the amount of invested capital in the case of a tax-free reorganization involving assets which have appreciated in value, since in such cases the tax basis ordinarily reflects only cost to some preceding owner and not taxpayer's cost. This rule can also operate to produce an invested capital much higher than taxpayer's cost, in cases involving the reorganization of companies in whose asset account is included a large amount of unrealized depreciation. The merits or demerits of the tax basis rule will not be discussed here, except to say that its advocates argue that to urge a cost rule is in effect to insist upon the reflection of earning power, which should already be adequately reflected in the average earnings credit. They point out that the invested capital credit is intended to represent an entirely different theory, that of original investment, and that it is really a relief credit, available when the credit based on earning power proves unsatisfactory. Its opponents present the simple argument that it is ridiculous to say that, when $1,000,000 worth of property is paid in for a corporation's stock, its invested capital is only $100,000, because the corporation must take the property over for income tax purposes at the lower figure as a consequence of non-recognition of gain to the transferor.

(4) *Summary of Credit Structure Currently in Effect*

The Excess Profits Tax Act provides for two credits in determining adjusted excess profits net income, the invested capital credit and the average earnings credit.[7] Of these, the average earnings credit is now clearly the dominant credit, the invested capital credit being largely a relief credit. The structure of these credits may be briefly summarized as follows:

[7] Originally the taxpayer was required to make an irrevocable election on its return as to which credit was to be employed for the taxable year. Almost immediately, however, the election feature was abandoned, and the question of the applicable credit was made to turn on which resulted in the smaller tax, unless one or the other credit was specifically disclaimed on the return. Even the disclaimer provision has now been eliminated, and only the relatively simple rule remains that the applicable credit is that which produces the smaller tax.

A. Invested Capital Credit

The invested capital credit is 8% of the first $5 million of invested capital, 7% of the next $5 million, 6% of the next $190 million, and 5% of all over $200 million. Invested capital consists of money or property paid in for stock, as paid-in surplus, or as contribution to capital, plus accumulated earnings and profits, plus 50% of borrowed capital, less corporate distributions previously made to shareholders. This, however, does not represent present investment, but historical investment, because of the use of the tax basis rule. On the other hand, the only reductions of original capital which are taken into account are those resulting from distributions. Accumulated operating deficits are ignored. In addition to the basic sections, 714 through 720, dealing with the invested capital credit, an entire Supplement is devoted to the special problems arising out of corporate reorganizations and liquidations. In the case of reorganizations, the general effect is to carry over the predecessor's invested capital as nearly as may be, unless there is a shift from equity to borrowed capital or a capitalization of unrealized appreciation in the form of debt, in which case the indebtedness is treated as a distribution. The effect of this refinement is sometimes to produce a minus invested capital, as in the case where the *X* Corporation, with $100,000 of invested capital (all equity) but assets which have appreciated to $1,000,000, reorganizes into the *Y* Corporation, with $100,000 of stock and $900,000 of bonds, all the bonds representing capitalization of unrealized appreciation. The bonds will be treated as a distribution, producing equity invested capital of minus $800,000. Borrowed invested capital being only $450,000, the total invested capital is still a minus figure to the extent of $350,000. Another result of a reorganization is that the benefits of the deficit rule may be lost, except in a very narrow class of identity reorganizations the requirements of which will seldom be met. In the case of tax-free intercorporate liquidations, the general effect of Section 761 is to preserve the parent's invested capital where the subsidiary's stock was held at a cost basis, but to eliminate the underlying invested capital of the parent and substitute therefor that of the subsidiary where the stock was held with a substituted or carryover basis. Detailed discussion of these provisions will be found elsewhere in this issue.

B. Average Earnings Credit

This credit was never really fully developed at the start, and its development subsequently has come largely through the refinements to be found in the relief sections. The basic average earnings credit consists of 95% of the taxpayer's average base period net income, plus 8% of any net increase, or minus 6% of any net decrease, in paid-in capital after the close of the base period. Average base period net income is either the arithmetical average of the taxpayer's experience for the base period, or an amount equivalent to the average for the second half of the base period, plus one-half the excess of such average over that for the first half. If the general average method is used, the taxpayer may substitute as the income for its

poorest year 75% of the average for the other three, but if the growth method is employed, actual experience must be used for all years (except for experience after May 31, 1940, in the case of fiscal year taxpayers, which need not be discussed here). Like the basic invested capital provisions, the basic average earnings credit provisions are accompanied by a Supplement—Supplement A—covering certain types of reorganization. The function of this Supplement is to provide for a carry-over of base period experience from a predecessor to a successor corporation.

II. RATES

All the excess profits tax rate schedules until the present one have involved several brackets with graduated percentages. In the original subcommittee report, the following rate schedule was recommended:

25% of so much of the adjusted excess profits net income as does not exceed 10% of the excess profits credit;
30% of so much of the adjusted excess profits net income as exceeds 10% of the excess profits credit and does not exceed 20% of such credit;
40% of so much of the adjusted excess profits net income as exceeds 20% of the excess profits credit.

Obviously, under such a rate schedule the dollar amount includible in each bracket would vary from taxpayer to taxpayer. But it was precisely this which recommended it. The brackets being based upon degrees of excessiveness, there was no discrimination between the large and the small corporation.

This proposed treatment did not long survive consideration by the full committee, however. In the Bill as reported to the House the principle of graduated rates was preserved, but the brackets were measured by dollar amounts of adjusted excess profits net income and there were six brackets instead of three. Furthermore, there was a difference between the schedule applicable when the invested capital credit was used and that applicable when the average earnings credit was used. In the former case the schedule began with a tax of 20% on the first $20,000 of adjusted excess profits net income and increased by 5 percentage points in each bracket until the maximum rate of 45% on so much of the adjusted excess profits net income as exceeded $500,000 was reached. In the latter case, though the dollar amounts of the brackets were the same, the percentage range was from 25 to 50. In addition, taxpayer using the average earnings credit was required to pay a tax of 4.1% of its normal tax net income. The penalty which this system imposed on the use of the average earnings credit is obvious. It also noticeably favored small corporations as against large corporations by virtue of having fixed brackets measured by dollar amounts of adjusted excess profits net income.

In the Senate the discrimination against the use of the average earnings credit was violently attacked and, in the Bill as reported by the Finance Committee, it was eliminated. In lieu of the dual rate schedule in the House Bill and the additional penalty tax of 4.1% of normal tax net income, the reported bill contained

only one rate schedule, applicable to all taxpayers, being that with a percentage range from 25 to 50.[8] A floor amendment attempted also to eliminate the discrimination against large corporations which resulted from the method of measuring the brackets. This was done by expanding the provision already in the bill so as to make the determination of each bracket depend upon either a dollar amount of excess profits net income or a percentage of the excess profits credit, whichever of the specified amounts was larger. There was a lack of coördination between the dollar amounts and the percentages in each bracket, however. Consequently, a taxpayer whose income covered several brackets might find the applicability of one bracket controlled by one of the alternate rules and the applicability of another bracket by the other rule, with odd results. This provision did not survive in conference and the rate schedule which ultimately appeared in the Second Revenue Act of 1940 was the same as that contained in the reported Senate Bill.

One of the consequences of a shift in the House Bill to a rate schedule with brackets fixed on the basis of dollar amounts of adjusted excess profits net income was the creation of the concept of highest bracket amount. Obviously, under the rate schedules as proposed, considerable advantage would result from the reorganization of a large enterprise into a series of separate corporations, since by having the income accrue to a series of corporations in the lower brackets the comparatively high rates into which the bulk of the income would otherwise fall could be avoided. A complicated device was therefore invented for reducing the income taxable at the lower rates in the case of corporations formed under these circumstances, the object being to collect approximately the same tax from the group of corporations collectively as would have been payable if the enterprise had not split up. Fortunately, the 1942 rate changes, noted below, made this provision no longer necessary. It was therefore repealed and, in view of the unsatisfactory nature of the provision from the beginning, the repeal was made retroactive to the original Act.

The only rate change made by the Revenue Act of 1941 was to increase the rates in each bracket by 10 percentage points, but with the Revenue Act of 1942 the scheme of graduated rates was abandoned and a flat rate of 90% was substituted. This high rate is somewhat tempered by a ceiling provision, limiting the excess profits tax to an amount which, when added to the normal tax and surtax, will produce a combined tax not in excess of 80% of the corporation's surtax net income. A postwar credit is also provided, amounting to 10% of the corporation's excess profits tax. This credit may be availed of either by the acceptance of non-interest-bearing bonds which are non-negotiable and non-transferrable until the end of the war or through a credit for debt retirement in the taxable year. Both the 80% ceiling and the postwar credit were declared in the Finance Committee Report[9] to be for the purpose of cushioning the impact of the severe 90% rate in certain unusual cases and of providing incentive for economical management and funds for

[8] At the same time the normal tax rate was increased from 20.9% to 24%.

[9] SEN. REP. No. 1631, 77th Cong., 2d Sess. (1942) 29.

postwar rehabilitation in the case of all corporations subject to the excess profits tax. The only remaining concession to small corporations is the specific exemption, whereby the first $5,000 of income in excess of the excess profits credit is exempt from excess profits tax. Two attempts, one by the House and one by the Senate, have been made to raise this amount to $10,000, but without success.

III. RELATIONSHIP BETWEEN THE EXCESS PROFITS TAX AND THE INCOME TAX

One of the most vexing and controversial problems which has arisen in connection with the excess profits tax has been its relationship to the income tax. The fundamental question is whether the determination of excess profits is to be before or after the regular corporate income tax.

The answer which was given in the original Act was to compute the excess profits tax after taxes. This was accomplished by allowing the Chapter 1 tax to be taken as an additional deduction upon the conversion of normal tax net income into excess profits net income. In the case of the average earnings credit, of course, a similar deduction was required to be taken in determining base period net income.

But this system did not long survive. It was reversed by the Revenue Act of 1941, which, in lieu of allowing a deduction of the income tax in computing the excess profits tax, allowed the excess profits tax to be deducted in computing the normal and surtax.

This change has been productive of much criticism. Accusations have been made that it was instituted for no other reason than to increase the revenue. It has been argued that the Chapter 1 tax liability of a corporation is as much a fixed charge as any other item of operating expense and that true excess profits cannot be determined without taking it into account. On the other hand, there were a number of seemingly valid objections to the original provision. Under it, in effect, a corporation was permitted to use its excess profits to pay Chapter 1 taxes. If profits increased sufficiently, therefore, a corporation would be allowed to retain a larger proportion of normal profits than had been permitted before, despite an increase in tax rates to which all taxpayers were supposedly subject. This, as has been pointed out, amounted to a discrimination in favor of corporations with increased earnings as a result of the war as against other taxpayers not so situated, since, by in effect subjecting the normal earnings of such corporations to a smaller tax than before the war, it left the increased tax burden to be borne by corporations not fortunate enough to have increased income. It cannot be denied that there was something to be said for the position that the normal earnings of all taxpayers ought to be subject to the same relative tax burden and that excess profits should be treated independently, unaffected by any considerations of the normal tax.

Complete separation of the excess profits tax base and the normal and surtax base was not achieved by the 1941 Amendment. For, since only the excess profits *tax* was allowed as a deduction in computing the income subject to normal and surtax, the differential between the excess profits tax and the adjusted excess

profits net income was actually used as a tax base twice. With a maximum excess profits tax rate of 60%, this result could perhaps be justified, since it was apparently not the legislative intent to allow excess profits to be retained tax free to the extent of 40%. With the adoption in 1942 of a 90% rate, clearly a somewhat different situation was presented, calling for further consideration of this controversial subject. The solution adopted was to eliminate any tax deduction either way, but in effect to divide a corporation's income into two categories, normal tax net income and adjusted excess profits net income, subjecting each only to its own tax. It is believed that the correct solution has finally been reached and that the present provision is immune to attack.

It will be noted that the change from the 1940 to the subsequent policy had a more severe effect in the case of the invested capital credit than in the case of the average earnings credit. This was because the disallowance of the normal tax as a deduction increased the excess profits net income for the taxable year without making any corresponding change in the credit. On the other hand, while the current excess profits net income under the average earnings credit was likewise increased, there was also an increase in the credit, less in amount, it is true, but substantial nonetheless, arising from the fact that the income taxes on base period income were no longer deductible in computing average base period net income. As a result, many taxpayers who had found the invested capital credit more beneficial in 1940 found the average earnings credit preferable for 1941 and subsequent years.

IV. Computation of Excess Profits Net Income

The income against which the excess profits credit and the specific exemption are allowed and the remainder of which is subject to the excess profits tax is not the net income or the normal tax net income, but the excess profits net income. As in the case of most, if not all, the special types of net income found in various parts of the Internal Revenue Code, however, it is not computed *de novo,* but is a derivative of an already ascertained figure. Excess profits net income is a conversion of normal tax net income through adjustment of certain items of income, deductions, and credits.

In a loose sense it may be said there are two branches to the question, what are excess profits? The first is, how much? The second is, what kind? The answer to the question of how much is the excess profits credits, which have already been discussed. The answer to the question of what kind is found in the adjustments applied in the conversion of normal tax net income to excess profits net income. Some of these are mechanical, while others involve questions of essential policy. Broadly speaking, there are three categories under which these adjustments may be discussed: (1) Adjustments related to the excess profits credit, (2) elimination of non-recurrent items, (3) relief. The last category will, however, be reserved until the section on relief generally.

(a) *Adjustments Related to the Credit*

The adjustments in this category are largely self-explanatory and have been the subject of little controversy.

It will be recalled that borrowed capital constitutes an element of invested capital to the extent of 50%. Since the excess profits credit based on invested capital will include an allowance of from 8 to 5% on half the corporation's borrowed capital, to allow the interest on the entire borrowed capital to be deducted would obviously result in duplication. From the first, therefore, half the taxpayer's interest deduction which is related to borrowed capital has been eliminated if the invested capital credit is employed.

Another invested capital concept which is reflected in the income computation is the concept of inadmissible assets. The credit feature in this instance, however, is rather the effect than the cause of the corresponding income adjustment. Inadmissible assets consist of stock, wholly tax-exempt federal, state, and local government bonds, and partly tax-exempt federal bonds. To the extent that corporate funds are invested in this type of asset invested capital is reduced. The measure of reduction is the ratio of such assets to total assets.

The corresponding income adjustment consists of the exclusion of income from these sources. In the case of corporate stock, the dividends received credit is increased from 85% to 100% and is broadened to include foreign as well as domestic dividends. In the case of wholly tax-exempt federal, state, and local government bonds and partially tax-exempt federal bonds, the same result is achieved without the necessity of specifying an adjustment, since interest from these sources is already excluded from gross income under Section 22(b)(4) or allowed as a credit under Sections 13(a)(1) and 26(a). The low rate of return often prevailing on this type of security, however, was thought to make it unfair to require taxpayers in all cases to follow the system of excluding such income and suffering the credit adjustment which the treatment of the bonds as inadmissible assets involved. An option has therefore been conferred upon taxpayers to waive the privilege of tax exemption on such securities for excess profits tax purposes, with the result that the interest received is included in excess profits net income, but in return the taxpayer is not obliged to treat the bonds as inadmissible assets. The effect is to benefit taxpayers, particularly banks and other financial institutions, to the extent that the increase in credit exceeds the income which is thus made subject to tax. In determining whether to avail itself of the option, however, a taxpayer cannot merely compare the invested capital percentages with the interest rate on the bonds, since the inadmissible asset adjustment, being based on a ratio rather than a direct subtraction, will ordinarily fail to correspond with the face amount of the bonds.

It has no doubt been observed that the income adjustments which have been discussed above are all related to the invested capital credit. In the case of the average earnings credit, the problem is merely one of correspondence between the base period and the taxable year computations.

(b) *Elimination of Non-recurrent Items*

The type of adjustment falling under this heading was declared in the original House Report to be "the adjustment of income to take care of * * unusual and non-recurring items" in the interests of "equity and the removal of hardships which would otherwise occur."[10] More directly than the adjustments discussed under the preceding heading, these adjustments involve the fundamental problem of determining the kind of income which ought to form the basis for computing an excess profits tax.

The first and most important of these adjustments is that requiring the elimination of long-term capital gains and losses in the computation of excess profits net income. This adjustment has existed from the beginning. A discussion of the pros and cons of this treatment is not within the scope of this article, but it may be pointed out that, though capital gains may in some cases represent income attributable to the war, the isolated nature of capital transactions, the varying periods over which the gain may have accrued both before and after 1940, the fact that a taxpayer may merely refuse to realize a gain if the tax rates are too high, and other factors peculiar to this type of income militate against subjecting it to an excess profits tax. The exclusion of corresponding losses is, of course, merely the normal corollary to the exclusion of gains.

Little change has been made in this adjustment since the original subcommittee proposal in 1940. It should be observed, however, that that recommendation assimilated depreciable property with capital assets, with the result that gains and losses from the sale or exchange of depreciable property held over 18 months were likewise eliminated. The Senate modified this treatment to the extent of providing for exclusion only in the case of net gains resulting from this source. A net loss on sales or exchanges of depreciable property held over 18 months was allowed in full.

Of course, the reduction in holding period from 18 months to 6 months in the amendments made to Section 117 by the 1942 Act had the effect of indirectly modifying the adjustment here under discussion. Furthermore, the elimination of a full deduction of capital losses for income tax purposes permitted deletion of any reference to capital losses in the Excess Profits Tax Act. Likewise, the enactment of Section 117(j) made a specific reference to depreciable property no longer necessary, since that provision has the effect of making a net gain a capital gain, excludible under the provision dealing with long-term capital gains, while providing that a net loss is to be treated as an ordinary loss, free of the restrictions in respect of capital losses. But these changes are merely technical and do not bear upon excess profits tax policy.

An additional income adjustment incorporated in the original Bill, and one so close to the capital gain adjustment as to be considered almost an expansion of it, was the exclusion of any income derived from the retirement or discharge by a

[10] H. R. REP. No. 2894, 76th Cong., 3d Sess. (1940) 8.

corporation of its bonds if such bonds had been outstanding for more than 18 months prior to the retirement or discharge. Obviously such an item of income would be non-recurring and, being a peculiar type of income in the first place, scarcely of the kind that should be subjected to an excess profits tax.

As the Bill progressed through the various stages of its enactment a number of other adjustments were added. No particular significance attaches to them, however, since they represented no change in policy, but merely a perfection of the Bill. Thus, the Senate excluded income arising from refunds of processing tax, since this represented in effect merely a compensating adjustment for a deduction taken in 1935 or a prior year. Similarly, bad debt recoveries attributable to indebtedness which had been charged off prior to 1940 were also excluded, since here too the income was merely to offset a prior deduction, was not a current business item, and could easily be classed as "an unusual and non-recurring" item.

Reference has already been made to the elimination of intercompany dividends in the case of the invested capital credit. A similar elimination is made in the case of the average earnings credit, though foreign dividends are not included. This divergence is difficult to explain in principle and is only partly alleviated by the opportunity to treat foreign dividends as potentially abnormal income under Section 721. The divergence was even wider in the original subcommittee report and Ways and Means Committee Bill. If the average earnings credit was used, no additional dividends received credit of any sort was allowed. When the Bill reached the Senate the same treatment was provided as in the case of the invested capital credit, but this amendment was compromised in conference by excluding foreign dividends from its scope. It was in connection with this compromise that the foreign dividends category was added to the classes of potentially abnormal income recited in Section 721.

The discussion under this heading has dealt with adjustments in the conversion of normal tax net income into excess profits net income for an excess profits tax taxable year. It is also necessary, where the average earnings credit is used, to determine excess profits net income for each of the years 1936, 1937, 1938, and 1939. This is done in the main by making the same type of adjustments as are made in the taxable year, the starting figure being normal-tax net income or its equivalent under the Revenue Act in effect for the period in question. But the following additional adjustments require to be noted:

(1) In addition to the adjustment on account of income resulting from bond retirements, there is a similar elimination of deductions for losses, expenses, etc., resulting from the same type of transaction. Through an oversight, the change from an 18 to a 6 month holding period in the case of capital gains and losses under the 1942 Act was overlooked in this instance and no corresponding change has been made in the bond retirement provision.

(2) Casualty, demolition, and similar losses are disallowed.

(3) Deductions for repayment of processing tax to vendees are disallowed under limitations.

(4) Various deductions, abnormal in kind or in amount, are disallowed.

In addition, for purposes of attaining uniformity in the base period and taxable year computations, the current capital gain and loss provisions are to be applied, including the provisions dealing with carry-overs.

V. RELIEF

It is on the subject of relief that the excess profits tax has undergone its greatest development since the original Act of 1940. The term "relief," however, is probably a misnomer. The provisions in question are more properly to be called refinements of either the income or the credit computations. They are not acts of grace operating in defiance of the excess profits concept, but perfecting amendments in furtherance of basic policy.

The subcommittee report of August 8, 1940, contained a separate section on the subject of special relief provisions, stating that the need for special assessment under the proposed plan was much less than during the World War period. Seven reasons were listed in support of this statement. Briefly summarized they are as follows: the inclusion of an average earnings credit, the inclusion of borrowed capital in invested capital, the inclusion in invested capital of the tangible property paid in for stock without any percentage limitation, the exclusion from excess profits net income of long-term capital gains and losses, the fixing of a floor upon the rate of return allowed for invested capital purposes, the allowance of special rates on new capital, the filling in of vacant years in the base period for invested capital purposes at a 10% and 8% return based on invested capital as of the close of the base period. The subcommittee therefore recommended no special relief provisions except in cases where the Commissioner could not determine the taxpayer's equity invested capital at the beginning of the first excess profits tax taxable year. This recommendation is now embodied in Section 723 of the Code, and is commonly referred to as the lost books provision. It is scarcely a relief provision, however, in the generally accepted sense, but merely provides a rule for the computation of equity invested capital in cases where the absence of the necessary information prevents computation under the general rules of Section 718.

The full Ways and Means Committee professed to have made somewhat more elaborate provision for special relief than its subcommittee had done. But upon analysis the full Committee is discovered merely to have adopted a slightly different definition of special relief from that adopted by the subcommittee. Among the provisions claimed to have been included was that relative to the elimination of long-term capital gains and losses in the computation of excess profits net income, a provision also recommended by the subcommittee but considered by it not as an example of special relief but as a mitigating circumstance which made special relief unnecessary. The other provisions denominated special relief provisions which were

included in the reported House Bill were the adjustment for repayment of processing tax to vendees, the adjustment for casualty losses, the adjustment excluding income from the retirement or discharge of bonds, and the provision allowing paid-in capital to be unaffected by operating deficits. Some of these adjustments were to base period net income and, by increasing the amount of such income, operated to increase the credit.

The Senate added several further adjustments of the same general nature, and more were added by the Excess Profits Tax Amendments of 1941, some of which in a limited way tended to cure base period abnormalities. The Senate also added Section 721, dealing with abnormalities in the taxable year—which will be discussed below. The really important provision on the subject of relief, however, was the provision added on the floor of the Senate granting the Commissioner the authority to make any adjustments which abnormally affect income or capital and making his decision subject to review by the Board of Tax Appeals (now The Tax Court of the United States). This provision was completely devoid of standards and was so vague and general that it was never considered as a definitive enactment. It was included merely to have something in the Act on the subject of general relief which would operate as an inducement to the Treasury and members of the Joint Committee Staff to work out a more carefully considered provision in the immediate future. Indeed, it was in effect so stated in the conference report. The promised revision appeared in the Excess Profits Tax Amendments of 1941 and was further enlarged and perfected in the 1942 Act. This important subject will be discussed below.

It is natural that, as experience has been accumulated and the burden of the excess profits tax has become more severe because of rate increases and other changes, other refinements than those contained in the original Act or specifically indicated for further study have been made. In accordance with the real nature of these provisions, the following discussion will be grouped under three headings: (a) Refinements of income computation, (b) Refinements of credit computation, and (c) Reconstructed base period experience.

(a) *Refinements of Income Computation*

(1) *Carry-Over and Carry-Back*

Of primary importance is the system of carry-overs and carry-backs which has been devised to mitigate the hardships of a strict application of the taxable year concept in the case of a tax such as the excess profits tax. The original Act, as finally approved, contained only a limited unused excess profits credit carry-over, restricted to one year and applicable only to corporations whose normal tax net income did not exceed $25,000. At an early stage the Bill had contained a two-year carry-over applicable to the canning industry alone, but this was eliminated in conference. The limited one-year carry-over above described never in fact became effective, because, before the first year in which any carry-over became available, the

Excess Profits Tax Amendments of 1941 provided a full two-year provision on the order of the net operating loss deduction. A two-year system of carry-backs has been added by the Revenue Act of 1942, that is, an unused excess profits credit in any year may be availed of until exhausted as a further offset to income in the two preceding and two succeeding taxable years in chronological order. The first year to which a carry-back may be taken is 1941. This combination of carry-overs and carry-backs should go far to averaging excess profits over a sufficiently long period to prevent the type of hardship which would otherwise result from an uneven profit experience.

(2) *Income Related to Other Years*

Any tax in which the annual volume of income and the time of its realization are as important as they are in the excess profits tax presents the problem of the realization in one year of income attributable in whole or in part to one or more other taxable years. Conspicuous among these types of income is income arising from a claim, award, judgment or decree, from a long-term contract, or any other type of income which was earned or the foundation for which was laid in some taxable year other than that in which it is includible in gross income under the tax laws.

The hardship which might arise in these cases was early realized, and a special provision extending relief was included in the original Act. This relief took the form of permitting a reallocation of the income to the years to which attributable. An alternative tax was then provided for the taxable year, consisting of an amount computed without including in gross income the income attributable to other years, plus the additional tax which would have been payable for the years involved in the reallocation if the income attributable thereto had actually been realized in such years. Subsequent revenue acts have made substantial improvements in the mechanics of this section, but there has been no alteration of its basic policy.

In addition to the types of income already mentioned, the section extended this treatment to income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, or processes, income includible in one taxable year rather than a different one by reason of a change in accounting period or method of accounting, income resulting to a lessor from the termination of a lease, and income consisting of foreign dividends. No change in these categories has taken place since 1940 except for the inclusion by the Excess Profits Tax Amendments of 1941 of a catch-all clause embracing any other types of income after classification pursuant to regulations of the Commissioner. An over-all limitation has been present from the beginning, denying relief unless the income in question is abnormal, either in kind or in amount.

A controversy involving this provision, which should be mentioned in passing, has been whether abnormal income in the taxable year which is attributable to a base period year should have the effect of increasing average base period net income,

and consequently the average earnings credit. The Finance Committee report indicated that this was to be the case,[11] but changes in language as the Bill passed through the Conference Committee appeared to the Treasury to prevent it. Consequently, the regulations took the contrary view. This controversy has now been settled by the Revenue Act of 1942, which makes it plain that Section 721 is to have no effect upon the computation of base period net income. However, a special provision was enacted covering long-term contracts, under which, by permitting taxpayers to elect to redetermine income on a percentage of completion basis for all taxable years, including the base period, the reallocation of income is allowed to increase average base period net income. It will be noted that this privilege is accompanied by the requirement that income of the same nature attributable to years prior to 1936 be eliminated.

(3) *Installment Income*

The problems relative to installment income bear many resemblances to those which called forth Section 721. Yet it was not until the 1942 Act that any provision was made for adjustment in hardship cases of this character. The reason for this delay, as will be seen from the nature of the problem, is probably that restrictions on installment selling and upon the production and sale of civilian goods are a 1942 phenomenon.

The difficulty in these cases is that, though the taxpayer reaches a year when its volume of business has dropped or down payments are required to be larger, with a resulting increased income reflection of current transactions, nevertheless a large volume of past transactions continues to be reflected in income because of collections on prior installment sales. To meet this problem, Section 736(a) now grants taxpayers the privilege of recomputing all installment sales on the accrual basis for excess profits tax purposes. All excess profits tax taxable years must be converted to this basis, however, and, furthermore, for the privilege to arise at all, there must be a variance of more than 125% between the current year and the four preceding years either in the volume of credit extended to purchasers on the installment plan or in the average outstanding installment accounts receivable at the end of each year.

(b) *Refinements of Credit Computation*

Much of the development of the Excess Profits Tax Act bearing upon refinements of the credit has already been discussed. Both the growth formula for computing average period net income and the evolution of the deficit year treatment have been fully set forth in the section dealing with the excess profits credit. The only remaining significant development other than Section 722, which will be discussed under (c), is the subject of abnormal deductions in the base period.

In the original Excess Profits Tax Act provision was made for the elimination of abnormal deductions in the base period arising from judgments, awards, decrees, etc. or from development expenses in the case of mines and oil or gas wells. The

[11] SEN. REP. No. 2114, 76th Cong., 3d Sess. (1940) 16.

object being to determine an amount of income representing normal earnings, it was felt that equity required that excessive reduction on account of abnormal items be avoided. The field in which this principle was allowed to operate, however, was obviously very narrow. Nor was any exception made for those cases where the same type of abnormality existed in the taxable year.

The Excess Profits Tax Amendments of 1941 both expanded and refined the concept materially. More precise abnormality tests were provided and, though the original categories were retained, a third subparagraph was added which brought all deductions, properly classified, within the scope of the adjustment policy. Furthermore, a series of limitations was devised to prevent increase of base period net income except in meritorious cases, considered from the point of view of the excess profits tax taxable year as well as of the base period year itself.

No changes have been made in the treatment of abnormal deductions since the spring of 1941.

(c) *Reconstructed Base Period Experience*

The most important of all the so-called relief sections is Section 722, which deals with the use of a constructive average base period net income as the foundation for an average earnings credit in abnormality cases.

As has already been mentioned, Section 722 of the original Act, added by the Senate, was only four lines in length and was not inserted as a definitive provision, but as a stop-gap pending further study of the problem. This temporary provision read as follows:

> Sec. 722. Adjustment of Abnormalities in Income and Capital by the Commissioner.
> For the purposes of this subchapter, the Commissioner shall also have authority to make such adjustments as may be necessary to adjust abnormalities affecting income or capital, and his decision shall be subject to review by the United States Board of Tax Appeals.

The history of general relief, therefore, really in effect begins with the Excess Profits Tax Amendments of 1941, Section 6 of which completely rewrote Section 722, expanding it from four lines to more than two pages in length. The authority to correct abnormalities in invested capital was withdrawn and the section confined to the adjustment of abnormalities in base period net income. Relief was made to depend upon the establishment by the taxpayer that his business as of January 1, 1940, was different in character from that engaged in during one or more base period years, or that in one or more base period years normal production, output, or operation was interrupted or diminished because of abnormal events. Furthermore, the statute provided that a difference in the character of the business would be considered to exist only if there was a difference in the products or services furnished, in the capacity for production or operation, or in the ratio of non-borrowed capital to total capital, or if the taxpayer was in existence during only part of its base period or if, prior to January 1, 1940, the taxpayer acquired all or part of the

assets of a competitor, thereby reducing or eliminating competition. Assuming eligibility under the provision, the abnormality or abnormalities in question were to be cured by the use of a constructive average base period net income representing what would have been earned had the abnormality or abnormalities not been present. Relief was to be had solely by way of refund or offsets to proposed deficiencies, until a constructive average base period net income had been established, when the Commissioner could authorize use of the new credit on subsequent returns. In order to limit the number of claims and to insure that some excess profits tax would be paid in any event, the statute provided that relief was not to be available unless it reduced the tax by more than 10% and that, even where available, the relief should be limited to the amount by which the tentative reduction in tax exceeded 10% and should not be allowed to bring the tax below 6% of the taxpayers normal tax net income for the taxable year.

Study of the subject of general relief continued even after the enactment of the 1941 provision. For the better part of the year the Bureau of Internal Revenue and the Treasury were engaged in assembling a dossier of hardship cases with a view to further expansion of Section 722. This study culminated in the revisions made by Section 222 of the Revenue Act of 1942, which greatly liberalized the section. The amended section may be applied retroactively to 1940. Among the more important amendments made was the extension of the section to cover taxpayers not previously entitled to use the average earnings credit—primarily domestic corporations organized after December 31, 1939.

The basic test which the taxpayer must now meet in order to establish a claim for relief under the amended section is that the excess profits tax otherwise computed results in an excessive and discriminatory tax. Citeria for this determination are set forth in the statute. All the tests by which abnormality was established under the former Section 722 are retained, but many new situations have been added. In the case of a taxpayer in existence prior to January 1, 1940, and therefore one entitled to use the average earnings credit, relief is available if (1) base period operations were impeded by an abnormal event such as a strike, fire, or flood; (2) the taxpayer's business was depressed in the base period because of a temporary economic circumstance, unusual in the case of taxpayer or the industry of which it was a member; (3) the base period of the industry of which the taxpayer was a member does not coincide with the general business cycle; (4) the taxpayer commenced business or changed the character of its business during or immediately prior to the base period; or (5) the taxpayer can point to any other factor affecting its business which may reasonably be considered as resulting in an inadequate standard of normal earnings during the base period, provided the application of the section in such case would not be inconsistent with the principles underlying (1), (2), (3) and (4) and with the conditions and limitations enumerated therein.

The category relating to the change in the character of the business includes as illustrations all the instances listed in the prior section plus the additional situation

of a change in the operation or management of the business. Furthermore, this provision has been liberalized by taking into account increases of capacity completed after December 31, 1939, as the result of a course of action to which the taxpayer was committed prior to January 1, 1940. Opportunity is also afforded to take account of normal growth, by permitting the taxpayer, in computing its constructive average base period net income, to assume that its business began, or the change occurred, two years earlier than was actually the case, if this produces a higher earning level by the end of the base period.

The right to relief in the case of corporations organized after December 31, 1939, is grounded on the inadequacy of the invested capital credit. Such inadequacies must be based upon one of three factors, *viz.*, (1) taxpayer has intangible assets which make important contributions to income but which are not includible in invested capital; (2) the taxpayer's business is of a class in which capital is not an important income-producing factor; or (3) the taxpayer's invested capital is abnormally low.

The 6% and 10% limitations on relief, which ruled out many taxpayers under the former provision, have been eliminated. Recognition is also given to the hardship of applying Section 722 only by way of refund. Taxpayers more than half of whose income would be subject to excess profits tax without regard to Section 722, may claim the benefits of Section 722 upon their returns and defer the payment of 33% of the reduction in excess profits tax claimed to result from its application. This tax deferment is without a corresponding adjustment in the normal and surtax and therefore amounts to considerably more than 33% of any net reduction in total tax.

The test of these provisions will come in their administration. The subject is such that precise rules cannot be laid down, but the major matters of determination must be left to sound judgment.

VI. Treatment of Special Types of Corporations

(a) *Mining Companies*

From the earliest excess profits tax days, the contention was forcefully advanced that special treatment should be provided for natural resource industries. Two purposes were alleged: (1) to encourage the production of "strategic" metals, and (2) to afford some relief where the war has not actually produced any greater profit to the mine owner, but merely caused acceleration in the conversion of a wasting asset into current income.

To take care of the first type of situation, the Senate, in 1940, incorporated a special provision in the Bill exempting from excess profits tax profits attributable to the mining of certain minerals considered to be strategic and in need of an incentive to production, *viz.*, tungsten, quicksilver, manganese, platinum, antimony, chromite, and tin. The exemption did not take the form of an exclusion from income, but merely provided that the tax otherwise computed should be reduced in the same

proportion as the exempt income bore to the taxpayer's total income. This provision was repealed in 1941 on the ground that "these corporations which make money out of the defense program should bear their share of the tax burden,"[12] but was restored in 1942 at the request of the War Production Board. This restoration was made retroactively applicable to 1941, thus avoiding any gap in the application of the section. Furthermore, four new metals, sheet mica, tantalum, vanadium, and nickel, were added, producing a list of eleven metals to which special treatment is now accorded under Section 731.

To provide relief for wasting asset industries—the second of the purposes enumerated above—a complicated provision was inserted in the Code by the Revenue Act of 1942, applicable to a long list of natural resource products, not including oil or gas. In general, the new provision excludes from income an amount representing normal profits upon exempt excess output for the taxable year, exempt excess output being a percentage of excess output (that is, the amount above normal), graduated with reference to the estimated number of recoverable units in the property. This method of computation benefits primarily short-lived mines and not those with large reserve deposits. Coal and iron mines are given an alternative method of computing the income to be excluded. In such cases, it is necessary only to multiply the excess output by one-half the net income per unit of production for the taxable year. A like rule is applied to timber, but without the privilege of an option. Provision is also made in Section 735 for exclusion from income of bonus payments made by United States agencies for production in excess of specified quotas.

(b) *Personal Service Corporations*

Personal service corporations have from the beginning been given the option of being subject to the excess profits tax or claiming exemption, but if exemption is claimed, the corporation's shareholders are taxed on their *pro rata* shares of the corporate income for the year, whether distributed or not. The only question of policy has been the definition of the type of corporation to which these provisions shall apply.

The original House Bill defined such a corporation as one in which invested capital is not a material income-producing factor and whose income is primarily attributable to the activities of shareholders who are regularly engaged in the conduct of its affairs and who, in the aggregate, own at least 80% of its stock. It was also provided that foreign corporations and corporations 50% or more of whose gross income consisted of gains, profits, or income derived from trading as a principal were excluded. Though attempts were made in the Senate to broaden the classification and the Bill as it went to conference was extremely confusing, the House provision survived, except for a reduction from 80 to 70 in the percentage of stock ownership required of active shareholders. No changes have been made in this provision since 1940.

[12] H. R. REP. No. 1040, 77th Cong., 1st Sess. (1941) 26.

It is obvious that many corporations find it difficult to comply with the statutory requirements. Either an amount of capital is required to finance operations which makes it impossible to say that capital is not a material income-producing factor, or the business has become so large and requires so many employees that its income cannot be said to be primarily attributable to the activities of shareholders. Many such corporations will find it necessary to look to Section 722 for relief from what would otherwise be an inequitable tax burden.

The 1942 Act provided that the benefits of personal service classification are lost if the corporation is a member of an affiliated group filing a consolidated return. It is believed that this amendment is largely academic, for it is difficult to imagine a corporation that can meet the other tests of Section 725 and still be a member of an affiliated group.

(c) *Exempt Corporations*

For various reasons of policy certain corporations are specifically exempted from the excess profits tax. The list contained in the original Act has undergone no change in substance, and consists of the following:

(1) Corporations exempt from income tax under Section 101;

(2) Foreign personal holding companies;

(3) Mutual investment companies;

(4) Diversified investment companies registered under the Investment Company Act of 1940;

(5) Personal holding companies;

(6) Non-resident foreign corporations;

(7) Certain domestic corporations with a large portion of their income from foreign sources;

(8) Certain air-mail carriers.

In connection with the amendments of Supplement Q of Chapter 1, the 1942 Act combined (3) and (4) above, so that the Act now contains but one investment company exemption, which runs in favor of regulated investment companies as defined in Section 361 without regard to (b)(4). More important, however, is the removal of exemption privileges if a consolidated return is filed. This limitation is a consequence of extending consolidated return privileges for purposes of the income tax as well as the excess profits tax and is designed to insure that the affiliated group will be the same for both taxes.

(d) *Consolidated Returns*

Brief mention should be made of the privilege of filing consolidated returns, which was revived for purposes of the excess profits tax by the Second Revenue Act of 1940. A tax on excess profits, it was felt, might be capricious and unreasonable if applied on a separate corporation basis to a group of taxpayers which together constituted a single integrated economic entity. The 1942 Act completed the cycle by reviving consolidated returns for purposes of the income tax as well.

The rules governing consolidated returns are set forth in the Regulations[13] rather than the statute. They are exceedingly intricate and involved and require a separate study in themselves. For the purposes of this summary, it is sufficient to refer to the problem which was at the same time the most fundamental and the most difficult—the determination of consolidated invested capital. The choice lay between the so-called accounting method, which is to measure a subsidiary's capital by its parent's investment, and the so-called legal method, which eliminated the subsidiary's stock from the parent's capital and used the subsidiary's statutory invested capital as the measure. Both methods were adopted, depending on how the subsidiary's stock is held. If such stock has a cost basis in the hands of the parent, the accounting method is used. If the stock has a carry-over basis, the legal method is used. It is interesting to note the statutory sanction which has been given these rules in Supplement C, which deals with reorganization and liquidation transfers.

With the Revenue Act of 1942 the excess profits tax reached maturity. Further refinements in detail may be forthcoming, but evolution of basic concepts has probably ceased. The major problem is now one of administration which, insofar as Section 722 in particular is concerned, may well have an evolution all its own.

[13] U. S. TREAS. REG. 110.

THE CONCEPT OF EXCESS PROFITS UNDER THE REVENUE ACTS OF 1940-42

Carl Shoup*

Congress has developed a concept of excess profits during the past three years, vague on some points but fairly definite on others. It is not expressed in summary form anywhere in the four revenue laws that have initiated and revised the excess profits tax; the present paper is an attempt to distill it out and compare it with concepts designed for peacetime taxation.[1]

Implicit Distinction Between War Profits and Other Profits.—Although the tax law makes no formal distinction between profits due to the war and all other profits, it is evidently intended to reach only the former. The taxpayer is given the option to use either the base-period method or the invested-capital method, whichever results in the smaller tax.[2] As a consequence, the tax is not imposed on profits on the grounds that they are larger than they need to be to induce the firm to carry on at its existing level of output. If excessive profits in this sense were being received in the base period, they can be received in wartime free of the excess profits tax. Further evidence of the desire to tax only profits that are due to the war lies in the refinement of the base-period concept, discussed below, to approximate the peacetime earning power inherent in the corporation as it stood just before the defense effort of the United States got well under way.

Moreover, even an increase in profits over the level of the base period is exempt if that level was very low in terms of per cent of invested capital. Specifically, the taxpayer's option referred to above means that the law exempts any increase in profits over those of the base period up to the point where the wartime earnings are 5% (ranging up to 8% for smaller firms) of invested capital. This provision might reflect

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The present article is intended to reflect only the author's views.

[1] To facilitate this comparison, the order in which the topics are treated follows in general that employed in the author's *The Taxation of Excess Profits* (1940) 55 Pol. Sci. Q. 535, (1941) 56 *id.* 84, 226.

[2] An advance tabulation of data from taxable excess profits tax returns for 1941 (*i.e.*, with all or the greater part of the accounting period falling in 1941) received in the Bureau of Internal Revenue from the offices of the collectors through July 31, 1942, unaudited, show that the two methods were about equally popular in terms of number of returns (18,760 used the base-period method and 18,337 the invested-capital method); but the aggregate excess profits net income of the taxpayers using the base-period method was $7.0 billion, against only $3.4 billion of those using the invested-capital method. Treas. Dept., Bull., Sept. 1942, p. 71.

a belief that, even had the United States not become involved in the war, the corporations in question might have improved to the point of earning at least 5% (to 8%) in 1940 and the following years. But a simpler and probably more nearly accurate explanation is that Congress desired to give the depressed industries of the 'thirties, like steel and the railroads, a chance to make a certain minimum amount of profit out of the war, the minimum reflecting something more than was needed to keep them going during the war but perhaps something less than would be required over the very long run in peacetime.

The law makes no attempt to impose a higher tax rate on income from government contracts. Under the present tax, which varies from 72% to 81% after post-war refund, there is not much room for an added rate on such income. Renegotiation of contracts is perhaps considered to provide the extra safeguard needed, although in practice it may work the other way around, with renegotiators finding their task made bearable only by the thought that the Government will in almost any case get 72% to 81% of what is not renegotiated out. Perhaps the pattern of the last war will be followed, and any reduction in tax rate in the immediate post-war period be disallowed with respect to income from wartime government contracts.

Emphasis on Experience of the Particular Corporation.—The attempt to restrict the excess profits tax to war profits involves treating each taxpayer in the light of its own particular business history and prospects. The invested-capital method does not lend itself readily to this approach; the base-period method does. Congress has shown its preference for the individual-case approach by refining the base-period method and enlarging its scope in successive revenue acts. Indeed, the process of refinement has come close to creating a third, overriding measure for excessive profits, one calling for more individual treatment than even the test of actual experience. This third concept is difficult to define briefly, but it seems to be something like this: excessive profits are those in excess, not of the profit that the firm did earn in the base period, but of the profits that it could have earned in the base period if all through that period there had been fully operative the reasonably assured potentialities that the concern exhibited at the close of the last year of its base period and if the base-period years had been marred by no exceptional or unrepresentative physical or economic misfortunes. Or, as the Senate Finance Committee put it briefly, the excess profits credit based on income will be "predicated upon an amount which is a fair and just reflection of the normal earning capacity of the business."[3]

The 1940 law, with some exceptions, used the actual base-period experience of the taxpayer as a direct measure of what should be a tax-free return in the war years. But under the 1942 law, the actual base-period experience will in many cases be not so much a measure as a preliminary indicator, a starting point from which to build up a hypothetical statement of what might have happened to the particular corporation in question under fairly happy business conditions. Most of this building-up takes place under the auspices of Section 722 of the Internal Revenue Code, which was

[3] *The Revenue Bill of 1942*, SEN. REP. No. 1631, 77th Cong., 2d Sess. (1942) 197.

radically expanded by the 1942 act. The extent to which Congress is willing to have each case considered separately is indicated by the following illustrations, selected from the report of the Senate Finance Committee and the Treasury Regulations, in which an "excessive and discriminatory" tax could be avoided by a "constructive average base period income" that would be "a fair and just amount representing normal earnings":

Sec. 722(b)(1): "Fires or floods would be events hindering the operations of the business [in the base period]."[4]

Sec. 722(b)(2): ". . . assume that a corporation for a long period of years conducted business with one customer which, during the base period, it lost because such customer decided to manufacture the product it heretofore bought. The corporation would be compelled to develop a new market . . . a corporation which belonged to an industry the members of which were engaged in a price war during several base period years. As a result of sales below cost during those years, the members of the industry sustained losses. . . ."[5]

Sec. 722(b)(3)(A): "The machine-tool industry is a possible example of this type of business with a business cycle different from the general business cycle . . . retooling orders, furnishing the opportunity for profit, do not necessarily occur with every period of business prosperity."[6]

Sec. 722(b)(3)(B): ". . . a member of an industry which does not have an earnings experience which can be segregated into definite cycles. . . . An industry engaged in the preparation and canning of fruit is a possible example of this class of business."[7]

Sec. 722(b)(4) (change in operation or management): ". . . in 1936, a corporation was reorganized and the new directors made drastic changes in the management. . . . The effect of the changes in sales and production policies initiated by the new management was not reflected in the company's earnings until 1939. . . . In 1936 a company engaged in coal mining converted from a system of hand loading, under which it lost money, to mechanized loading. . . . In 1938 a concern which marketed its product from door to door changed such sales methods to direct sales to retailers. As a result, its earnings increased."[8]

(a difference in the products or services furnished): ". . . a corporation, which until 1934 manufactured snuff at a loss, in that year changed to the manufacture of cigars. Due to normal difficulties in establishing trade connections and in establishing its product, it did not realize normal earnings until 1938."[9] ". . . a corporation in one year of its base period was engaged in both the radio broadcasting business and the department store business and on January 1, 1940, was engaged only in the radio broadcasting business, the department store business having been discontinued . . . a corporation was engaged in one of the base period years in both the wholesale and retail dry goods business and on January 1, 1940, was engaged only in the retail dry goods business."[10]

(a difference in the capacity for production or operation): ". . . in 1939 a mining company began the development of a new mine and the construction of a new plant to be used in connection with such mine. . . . The mine and the plant were completed and entered production in November 1941. . . . In determining the amount of the constructive average base period net income, the extent to which the new facilities entered into the business of the corporation for the taxable year shall be considered to be the extent to which the character of the business was changed on December 31, 1939."[11]

[4] *Id.* at 198. The Regulations (Treas. Dec. 5045, May 3, 1941), p. 28, add strikes as another possibility.
[5] SEN. REP. No. 1631, *supra* note 3, at 199.
[6] *Ibid.*
[7] *Id.* at 199-200.
[8] *Id.* at 201.
[9] *Id.* at 200.
[10] Treas. Dec. 5045, May 3, 1941, p. 27.
[11] SEN. REP. No. 1631, *supra* note 3 at p. 202.

(a difference in the ratio of non-borrowed capital to total capital): No examples are given.

(acquisition of assets of competitor, diminishing or eliminating competition): ". . . two competing newspapers were operating at a loss during all or part of the base period. Prior to January 1, 1940, the first newspaper purchased the franchises and other assets of the second newspaper and as a result of this transaction the condition of the surviving paper was much more promising."[12]

(full effect of above changes in business, or commencement of business, not felt by end of base period): ". . . a corporation . . . in 1938, started a delivery route selling food products such as peanuts, potato chips, and similar products. For 1938 it showed a loss. Its earnings for 1939 increased in each quarter-year period. With a record of steady growth such corporation might be deemed to have commenced business in 1936."[13]

(any other factor resulting in an inadequate standard of normal earnings): ". . . assume that a taxpayer was organized in 1935 to distill and sell whisky. It had no reserve whisky stocks on hand. During 1935 and for the greater part of its base period, it was aging the whisky it had distilled. Because of a lack of a marketable product, the sales of such taxpayer, and consequently its base period net income, were abnormally low. . . ."[14]

The actual base-period earnings in each of these cases seems at first sight an obviously inadequate standard. But the inadequacy may be more apparent than real. Perhaps the interruption of production due to a flood merely resulted in a postponement of operations, with a consequent abnormal increase in business later in the base period. Perhaps the loss of the chief customer and the building up of a new market commonly occurs several times in the life of an enterprise in the industry under consideration; if it happens during an excess profits tax taxable year, no hypothetical increase in taxable profits is required. Price wars are "normal," in many industries, if the period in question is long enough. The difficulties of the individual-case approach are indicated by the absence of any definite standards, in the law, for the building up of the constructive, hypothetical base-period income, and by the provision of special administrative machinery to handle the cases. What standards will the Internal Revenue Bureau and the Tax Court follow?

Perhaps they will resort to something that might be called retrospective business cycle forecasting for the individual firm, by starting with its actual profits experience in the one or more years of 1936-1939 that were not affected by the strike, flood, fire, or price war, and by trying to fill in the missing years against the background of general business conditions. Still more imagination will be called for when the concern as it stood at the end of the base period, with its new product, its enlarged production capacity, its improved sales methods, and its rejuvenated management, is projected backward in time and assumed to be operating in an environment otherwise unchanged from what it was in 1936-39—or will account be taken of hypothetical changes in competitors' situations that would have been caused by these improvements?

The hypothetical base-period income might conceivably be arrived at by applying some percentage of fair return to the capital investment as it stood at the end of the

[12] Treas. Dec. 5045, p. 27.

[13] SEN. REP. No. 1631, *supra* note 3, at 201. [14] *Id.* at 203.

base period, but this solution would seem an almost direct negation of Congressional intent. The excess profits tax law as it now stands reveals a strong desire to avoid the use of the invested capital standard if the taxpayer can possibly be relieved in any other way. The extreme instance of this is Section 722(c)(3), which allows a taxpayer that was not in existence during the base period to build up a purely hypothetical constructive base period income if "the invested capital of the taxpayer is abnormally low." And a taxpayer that was in existence only part of the base period need not fill out the rest of the period by taking 8% of its invested capital as of the start of its first taxable year (Sec. 713(d)(2)) if it can do better by constructing a hypothetical income for the period.

Why has Congress gone so far down the path of individual treatment under unspecified standards, in view of the obvious difficulties? At least three reasons come to mind.

First, an accident of business cycle history blocked one remedy that could be cast in general terms, that is, lengthening the base period and thus lessening the distortion caused by the abnormal events of one or two years, or by the normal absence of a profits cycle synchronizing with that of the "general business cycle" (Sec. 722(b)(3)). Behind 1936 stretched the great business depression of the 'thirties. A split base period, say 1925-29 plus 1936-39, would have utilized experience too remote to be dependable. A lengthened base period would not, of course, help the taxpayer whose character of business was changed toward the end of the period.

Second, Congress has probably considered the tax to be a temporary one, imposed for a short war. Hence there is correspondingly smaller chance that abnormalities in the incomes of taxable years will be averaged out. This point concerns more directly Section 721, which defines "abnormal income" of a taxable year, but it also makes more important (in striving to protect all taxpayers against harsh treatment) the construction of a base period average that is free from unfortunate events that are abnormal for short periods, however normal they may be for long ones. If the excess profits tax were to last for ten or twenty years, there would probably be at least one price war, flood, or fire that would, to some extent, counterbalance the effect of the similar occurrence in the base period. But this point can easily be overemphasized. Even for a long-lived tax, a base period should have in it no more than a fraction of the effect of an unusual event, corresponding in size to the fractional effect in the annual average of profits over the taxable period.

Third, an invested capital standard can be made a general relief provision by giving the option to use it to the taxpayer, not the Government. The present law does give the taxpayer this option, but the percentage applicable to the invested capital has been set fairly low, evidently in order to get at least some excess profits tax from concerns whose booming war business contrasts sharply with a period of stagnation in 1936-39. The resulting excess profits tax credit under the invested capital option, although higher than that obtained by referring to actual base-period experience, may have appeared to Congress lower than what taxpayers with peculiar

base periods—not mere unrelieved stagnation—might properly hope for. The business world has so much in it of risk on the one hand, and monopolistic elements on the other, that a standard of 5 to 8% on invested capital probably falls considerably short of both expected and actual earnings of the majority of enterprises in industries that have not passed completely through the expansion phase. If the invested capital credit had been set at, say, 12%, the pressure for special relief provisions would presumably have been much less.

But even these reasons seem not fully to explain the partial disintegration of the base-period law into a series of special cases, especially since the legislators have provided three methods for the taxpayer within the framework of the base period itself. Under one of them, introduced in the Revenue Act of 1942, the credit is equal to 89.06 ¼% of the average of the income of the three highest income years of the base period.[15] Taxpayers with year-to-year fluctuations in base-period income so slight that they get a higher average base-period income by simply averaging the income of the four years are permitted, in fact required, to do so. Still others will use the third method, designed particularly for corporations that were expanding in the latter part of the base period; it utilizes a modification of the trend method known to statisticians as the "semi-average" procedure, adding to the average of the last two years one-half the difference in the average of the first two years and the last two (with the highest year's income as a maximum for the final figure). In the advance tabulation of 37,097 excess profits tax taxable returns, this option for "growth" corporations was very popular; of the 18,760 returns filed on the income method, 9,707—52%—used it.[16] At that time, however, the general average method was somewhat less favorably defined for the taxpayer than it is under the 75% provision noted in footnote 15 and the relative popularity of the "growth" method may decline somewhat.

In the light of these options, the chief significance of the constructive base period is the tendency it reflects to atomize the law, which presumably should instead be fairly general. It might be instructive to count the number of clauses already in the income tax[17] and excess profits tax laws designed in the first instance to care only for

[15] The law says, "If the excess profits net income (or deficit in excess profits net income) for one taxable year in the base period divided by the number of months in such taxable year is less than 75 per centum of the aggregate of the excess profits net income (reduced by deficits in excess profits net income) for the other taxable years in the taxpayer's base period divided by the number of months in such other taxable years (herein called "average monthly amount") the amount used for such one year under this paragraph shall be 75 per centum of the average monthly amount multiplied by the number of months in such one year, and the year increased under this sentence shall be the year the increase in which will produce the highest average base period net income. . . . "§713(e)(1). Hence the average base period excess profits net income cannot fall below the average of (a) the three highest years and (b) one year presumed to have an income 75% of that shown by (a). If (a) is 100, the result is

$$\frac{(100 \times 3) + (75 \times 1)}{4} = 93.75$$

Since the credit is 95% of the average base period net income, it is, in this case, 89.06¼% of the average of the income of the three highest years (disregarding subsequent changes in invested capital).

[16] TREAS. DEPT., BULL., Sept. 1942, at 71.

[17] It is the present writer's impression that examples are to be found in §116(d), 2d par., and §120 of the Internal Revenue Code.

one taxpayer and utilized by no other taxpayer since then. Section 722(b)(4) offers one of the more striking examples: ". . . any acquisition before May 31, 1941, from a competitor engaged in the dissemination of information through the public press, of substantially all the assets of such competitor employed in such business with the result that competition between the taxpayer and the competitor existing before January 1, 1940, was eliminated, shall be deemed to be a change on December 31, 1939, in the character of the business. . . ." Without passing on the merits of this particular case, and while agreeing that one-taxpayer clauses cannot be dispensed with entirely, it may be asked whether taxpayers should not be prepared to accept a certain amount of lottery element in a tax law and put up occasionally with a certain amount of inequity, for the sake of keeping the law from disintegrating into a case book. But if taxpayers are to accept this rule of the game, they in turn have grounds for demanding that the tax rate be kept a considerable distance below 100%. Asking the taxpayer to take a chance on being treated somewhat less favorably than a competitor is reasonable, but asking him to gamble his business life is not. A tax rate of 90% or 100% on a base so complex as that of the excess profits tax will almost surely ruin some taxpayers, if special relief is not provided either by administrative discretion or in the law. The present excess profits tax law, by employing a high rate on a narrowly defined base instead of a lower rate on a more broadly defined concept of excess profits, makes a substantial amount of detailed relief inevitable.

These remarks do not imply that the tax law should set no standards; if the legislators cannot devise generally applicable tests, it is unreasonable to expect the administrators or the courts to do so. The renegotiation statute,[18] by making no attempt at all to define "excessive profits," opened the path for treating each case as a special instance far more widely than does the Revenue Act of 1942. The point is, rather, that while the tax law can never be simple in the sense of failing to define standards, the number of sets of standards might be considerably less than in the present law.

In any event, and whatever one's preferences, all future students of the theory and technique of excess profits taxation will owe a debt of scholarly gratitude to the Treasury officials and Congressional committee members of 1940-42 for having explored the dark recesses of the base-period concept more deeply than any had dared to do before them.

General Standards under the Base-Period Concept.—Further evidence of the importance that Congress attaches to the base-period technique is the care that has been devoted to refining the general concept of base-period income. Here it is a question not of substituting hypothetical for actual data, but of adding, subtracting, or combining in various ways the entries that appear in the records of the taxpayer.

One class of adjustment allows the taxpayer to add back certain items that were deducted in the base-period years in computing net income for the ordinary income tax, or requires him to subtract certain items that he was not allowed to subtract (or failed to subtract) for income tax purposes. The general question then arises: shall

[18] Act of April 28, 1942, Pub. L. No. 528, 77th Cong., 2d Sess. §403.

analogous adjustments be required (or permitted) in the income of the taxable year? Long-term capital gains and losses, income from retirement or discharge of bonds, etc., and dividends from domestic corporations are not taken into account in computing the base-period income, and they are correspondingly ignored in computing the income of the taxable year. But there are several instances where such correspondence is not maintained; the adjustment is made, to the benefit of the taxpayer, in the base period, but he is not required to make an analogous adjustment in the taxable year. Examples are losses and expenses on the retirement or discharge of bonds, etc., and casualty, demolition, and similar losses. And a catch-all subsection (Sec. 711(b)(1)(J)) permits the adding back of "abnormal" deductions.

One of the tests employed is whether the base-period deductions (of a given "class") exceeded by more than 25% the average amount of deductions of the same class for the four previous taxable years. Thus a secondary base period is created, by which the primary one is tested; the secondary base period may extend back as far as 1932. This is probably the only instance in the history of excess profits taxation of a compound base period.

That a base-period income averaged over a short term of years should be purified to some extent of rarely occurring items like expenses of debt retirement or casualty loss is understandable. But should the purification in the base period be complete? Over the long term, those expenses do occur, although not perhaps to the extent that a completely unpurified four-year average of 1936-1939 experience would indicate. If the excess profits tax is not designed to last over a long term, however, the argument for complete elimination of the expense in the base period becomes stronger.[19]

Another class of adjustment provides a base-period history for a corporation that was not, in its legal self, in existence before 1940, but that has an unbroken business history extending back through one or more predecessor corporations, or even unincorporated concerns. The revision, in 1942, of the already highly elaborated Supplement A is again evidence that Congress considers the primary test for excess profits to be base-period experience, not a percentage return on invested capital.

The Invested-Capital Method.—The invested-capital method plays a dual role in the excess profits tax law: in some cases it supplements, and in others it replaces the base-period method.

As time passes and a concern expands or partially liquidates, its base-period experience, even when refined and reconstructed with the exercise of the most powerful imagination and ingenuity, becomes less satisfactory. Hence the provision allowing the addition, to the average base-period net income, of 8% of the net additions to capital since the end of the base period, and requiring the subtraction of 6% of the

[19] Moreover, there may be some danger of exaggerating the importance of these provisions. Of the 16,586 returns filed under the income method for calendar 1941 and for fiscal and part years beginning in, and the greater part of whose accounting period fell in, 1941, "the number with abnormal deductions in the base period is 1,282"—not quite 8%. TREAS. DEPT., BULL., Sept. 1942, p. 71. This is a much smaller percentage than the present writer had expected.

net capital reduction. Expanding concerns will thus, in time, be restricted to a return approaching 8% on their total invested capital, although they may have had base period earnings at a much higher rate on the amount of capital then invested. And shrinking firms will be allowed higher and higher percentage returns on what is left of their capital—a privilege that will probably be immaterial, or the concern would not be shrinking. But this section of the law (Sec. 713 (g)), although carefully worked out as far as it goes, does not allow the inclusion of borrowed capital, and provides only a flat rate of return; it therefore gives the impression that it is not expected to play a very important role.

As an alternative to the base-period method, the invested-capital method requires an estimate of the total amount of invested capital as of a certain date. The present law follows the (United States) precedent of the First World War in avoiding a current valuation of the assets actually in use in the business, and measuring instead the money and other property paid in to the corporation, plus earnings and profits accumulated subsequently. With some exceptions, appreciation in the value of assets —due, for instance, to the development of a quasi-monopoly position—is therefore not counted as a part of invested capital so long as it is unrealized and hence has not appeared in earnings and profits. The consequent impairment of vested property rights implicit in this refusal to take unrealized appreciation into account has been avoided by making the use of the invested capital method optional with the corporation, which can therefore rely on a rich base-period experience to free it from excess profits tax. The current profit may be 20%, or 100%, or any other per cent, of invested capital, without becoming subject to the excess profits tax, so long as it does not exceed the rate of return implicit in the actual or constructive base-period figure (and assuming no appreciable net addition to capital since 1939). Congress strenuously resisted the Treasury's efforts to turn the option in favor of the Government, as under the 1918 law. Evidently the protection of the current value of corporate shares was considered by Congress to be very important.

Giving the option to the taxpayer also protects corporations whose base-period experience has been so poor that no amount of "reconstruction" can get them a credit equal to more than a very low return on paid-in capital, surplus, and accumulated earnings and profits.

From the technical point of view, the chief features of interest in the present law's concept of invested capital are: (1) the tracing of the corporation's history back through tax-free reorganizations; (2) the use of basis (unadjusted) where property was paid in for stock, thus avoiding, with some exceptions, a new, direct valuation of the property as of that time, in cases where the value of the stock itself was not readily ascertainable; (3) the use of basis (adjusted) for determining the ratio of inadmissible assets to total assets; (4) the inclusion of part of borrowed capital; and (5) the refusal to limit the inclusion of intangibles. The first three will not be discussed here, since they do not represent a fundamental change in concept, although the use of basis is an important technical step in avoiding troublesome valuations.

Not even a summary of the issues involved in borrowed capital can be attempted here. But it may be observed that the present law gives them only a partial test.

In the first place, the law includes in invested capital only one half the borrowed capital, after excluding entirely all borrowings not evidenced by certain formal written instruments. This fraction represents a compromise between (1) the fear of hardship that exclusion of borrowed capital would cause, especially to young, growing corporations that must borrow heavily to take advantage of opportunities before they vanish, and (2) the fear that unlimited inclusion of borrowed capital would be abused by unnecessary borrowing on the part of strong corporations that could get loans at rates of interest so low that there would be a gain from the transaction even if the borrower could find no use at all for the money. It is virtually certain, however, that if the same amount of time had been devoted to strengthening the invested-capital concept as has been devoted to the base-period measure, a way would have been found to obviate such abuse, while retaining the advantages desired, and thus permitting the full inclusion of borrowed capital.

In the second place, the rate of return allowed on invested capital is set so low (5% to 8%) that in a few instances it is probably exceeded by the interest rate at which the taxpayer is borrowing. In these cases, the taxpayer would be better off if borrowed capital were excluded entirely and he were consequently allowed a full deduction, in computing excess profits net income, of interest paid, instead of being restricted to deducting half of the interest as at present.

The existing law makes no attempt to pioneer by including leased capital in invested capital. Instead—evidence again of the strong preference for the base-period approach—it apparently allows for the construction of an imaginary base-period income, for corporations not in existence before January 1, 1940, as shown by this illustration: ". . . a corporation . . . commenced business in 1941 with a leased plant valued at $1,000,000, but with invested capital paid in of only $40,000. Since the invested capital of such company is unusually low relative to the size of its operations, it would be subject to an unreasonable tax burden if required to compute its excess profits tax under the invested capital method. It would therefore be given constructive average base period net income and would be entitled to compute its credit on the average earnings method."[20]

The legitimacy of an intangible asset as a component of invested capital is fully recognized, in contrast to the excess profits tax law of the last war. And here again the predominance of the base-period approach is apparent. When the intangible has failed to get on to the taxpayer's books (technically, when it has no tax basis), as when it has arisen from outlays that have been charged off to expense, the inaccuracy is corrected, not necessarily by a revamping of the expense and capital accounts, but by building up a hypothetical (constructive) base period income:

"For example, a corporation, which was of a class requiring little invested capital but necessitating the establishment of contacts with the trade which it was its business to sup-

[20] SEN. REP. No. 1631, *supra* note 3, at 203-204.

ply, commenced business early in 1940. It lost money during its first 2 years of operations but by 1942 began to realize sizable profits. This company would be eligible to receive a constructive average base period net income on the grounds that one of its principal assets, the goodwill of its clientele, was not reflected in invested capital."[21]

Among the disadvantages of computing invested capital through the liabilities side of the balance sheet, instead of segregating out the assets actively used in the business and valuing them currently, there are several important ones that the present law does not remove. This is understandable so long as the invested-capital method is regarded as a sort of general relief provision for a short-lived tax based primarily on the income-credit method, for these disadvantages will probably not be serious during another two or three years of war.

One of them is the inducement offered to arrange a transfer of corporate ownership of the assets of a prosperous business with an earning power well above the tax-free return allowed on the corporation's invested-capital figure. If the sale of the assets, from one corporation to another, can be so arranged that it does not fall into the "tax-free" category, and if the hitherto unrealized appreciation in value of the assets, now realized by the sale, can be made to appear in the form of gains on "capital assets," the year's ordinary corporation tax is increased, but the excess profits tax is decreased for the current year and all future years: the net long-term capital gain realized upon the sale of the assets (in excess of the year's net short-term capital loss) is taxable under the ordinary corporate income tax at a maximum rate of 25%; but a new, high invested capital figure is created that will serve to exempt much or all of future income from the excess profits tax. So long as the tax is believed to be temporary, however, there is probably little danger of such tax-induced sales.

Conversely, if a corporation has sustained an unrealized loss in the value of its assets, any transfer of the assets, not under a "tax-free" exchange, will cause the loss to be realized and will in general make the assets worth less for excess profits tax purposes. Indeed, a similar deterrent to transfer exists even when the loss in value of assets has been realized, that is, has been reflected by the accumulation of a deficit in the earnings and profits account. The law does not require that such a deficit be deducted from the original capital and surplus paid in, in computing invested capital. But, with some exceptions, as soon as the assets are transferred to another corporation, whether or not under a "tax-free" exchange, the accumulated deficit becomes realized, in fact or in effect, in the computation of the invested capital of the transferee corporation. A corporation with assets having a present worth and an adjusted basis of $10 million, and outstanding stock of $25 million and an accumulated deficit of $15 million, can reckon its invested capital at $25 million; exceptions aside, if the assets are transferred to another corporation, old or new, they give rise to only $10 million of invested capital. There has been some evidence that the benefit accruing from holding on to a book deficit has impeded important reorganizations.

The present law does a little cautious pioneering in allowing for differences in

[21] *Id.* at 203.

risk. It does not explicitly refer to such differences, but they were the chief consideration in the enactment of the borrowed capital provision (a given amount of total investment is much more of a gamble at great odds by the equity owners if a large part of the investment is borrowed capital) and in the graduation of the permitted rate of return on investment, which now varies from 8% on the first $5 million of invested capital to 5% on the excess over $200 million. Graduation of this kind is a recognition of the tendency of risks to cancel out in large numbers; a small company drilling one oil well a year, for example, obviously faces more risk than a large one drilling many hundred. Mere size, other things being equal, itself lessens risk.

The Scope of the Tax.—The present law seems to reflect a desire to tax primarily, or even exclusively, excess profits derived from the employment of business capital in the corporate form. But the exclusion of profits derived chiefly from personal service reflects more a deliberate aim, a freely chosen limitation on the concept, than does the exclusion of all unincorporated enterprises, which was dictated by fear of administrative difficulties. If Congress could have been shown some easy way of isolating excess profits on capital employed in unincorporated enterprises, it would very likely not have restricted the tax to corporations. At least, it may be presumed that Congress did not aim at promoting disincorporation, which appears to have reached significant proportions in some industries, owing to the excess profits tax and the corporation tax. (The writer has the impression that this is the case with the women's garment manufacturing industry, for example). The exclusion of profits derived primarily from personal service, on the other hand, seems less forced by circumstances than by doubt over the soundness of a concept of "excess" personal-service income. Still, if that were so, why did not Congress grant outright exemption to those corporations "of a class in which capital is not an important income-producing factor" (Sec. 722 (c)(2)), like a corporation doing business as fashion consultants, employing a large technical and professional staff? Incidentally, in these cases, it becomes imperative to resort to a constructive base period income, if the corporation was not in existence before January 1, 1940. Both intent and execution remain somewhat unclear in this personal-service area of the "excess" concept.

Elimination of the One-Year Accounting Period.—"Elimination" is too strong a word to apply literally with respect to what has happened to the one-year accounting period under the income tax and the excess profits tax, but it is scarcely too strong if taken in the sense of end results over a period of years. In recent revenue acts, breaches have occurred at widely separated points in the barriers, necessarily somewhat artificial, that mark one year's income off from the next. The speed with which last-in first-out inventory accounting has gained favor for tax purposes is an illustration; the revival of the two-year carry-forward ("carry-over") of losses in the Revenue Act of 1939 is another. But it remained for the Revenue Act of 1942 to effect what will probably turn out to have been the most important change of this kind in any federal revenue law, by adding a two-year carry-back to the two-year carry-forward

and making it applicable not only to operating losses but also to unused excess profits tax credits. In effect, something approaching a five-year moving average has been introduced. There are probably better averaging methods available, but proponents of averaging will not be inclined to complain, in view of the size of this one step—if it really is a firm step. To mean much, the carry-back provision must be kept in force, even though the rest of the excess-profits tax is repealed, for some time after the war; and Congress and the public must be ready to accept the necessity of substantial refunds to corporations, including very large ones that will not be in financial distress, however good their claim may be on grounds of equity.

The net income derived from gross income of any given class, for the taxable year, may be decreased, for excess profits tax purposes, to the extent that it is "abnormal" either in nature or amount and can also be shown to be attributable to other years. Abnormality in amount is defined as being more than 25% higher than the average for the four previous taxable years. Consequently, any class of gross income that has been increasing for four years at an annual rate (compounded) of more than about 10% is "abnormal." But the Regulations make it clear that fluctuations due merely to changes in prices, costs, demand or competition do not make the abnormal income attributable to other years.

The net abnormal income gives rise to excess profits tax for the past or future years to which it is found attributable, except that if it falls in 1939 or an earlier year it has no effect at all, not even in the measurement of base-period income. Net abnormal income thrown into a future year cannot give rise to an added tax in such a year greater than the tax saved in the present year (minus the increase caused by this provision in intervening years). Hence the taxpayer cannot lose, by this averaging provision, no matter what happens to tax rates.

There may still be a practical problem of tax payment if the taxpayer is not provident. When the future year arrives, he will have to pay perhaps 90% of a substantial amount that he received, not in that year, but some years before. It will be interesting to observe whether this difficulty, considered by some to be a decisive objection to the moving-average type of income-averaging, proves important in practice. Surprisingly enough, the data for the 32,976 returns filed for 1941 (to July 31, 1942) indicate very little use of this relief for "abnormalities" of the taxable year: "The number of returns with abnormal income attributable to other years is 528."[22] In any event, the construction of and experience with this elaborate averaging device may easily have significant implications for post-war income tax legislation despite its intended inapplicability to profit fluctuations associated with the business cycle.

Income Tax and Excess Profits Tax.—The extraordinary increase in the yield of the excess profits tax on 1941 and subsequent incomes over that on 1940 incomes[23] is due in large part to the fact that in 1940 the normal tax and surtax were computed

[22] TREAS. DEPT., BULL., Sept. 1942, p. 71. The returns "filed for 1941" here include only those for fiscal and part years beginning in, and the greater part of whose accounting period fell in, 1941.

[23] Fiscal 1941: $164 million; fiscal 1942, $1.6 billion; fiscal 1943, estimated, $5.7 billion; fiscal 1944, estimated, $10.3 billion. *Budget . . . for . . . Fiscal . . . 1943*, p. A-3; *Budget . . . for . . . Fiscal 1944*, p. A-1.

first, and deducted from net income in computing the base of the excess profits tax, while in 1941 the excess profits tax (in 1942, the excess profits credit) was computed first and the normal tax and surtax were then applied only to the remainder. The change was motivated chiefly by a desire for the increased revenues it would bring, under a given set of rates, and did not reflect any fundamental change of mind concerning the proper concept, aside from the consideration advanced by the Ways and Means Committee that "It seems unfair to allow that part of the income tax which is computed on income which is not subject to the excess profits tax to reduce the excess-profits net income."[24] But the 1940 method itself did not reflect any profound convictions on concept. If the normal tax and surtax are assumed to be non-shiftable and are designed to give the Government a stated share in the corporation's standard, fair, or peacetime reward, the present system is logical. Moreover, as the excess profits tax rate approaches 100%, the 1940 system blurs the distinction between excess profits tax and normal and surtaxes; with a 100% excess profits tax rate and the normal and surtaxes deducted in computing the excess profits base, a decrease in the normal and surtaxes would bring the taxpayer no gain and an increase, no burden. Under the present system, a variation in the normal or surtax rates has a real meaning for the corporation, regardless of the excess profits tax rate. But, assuming a given set of normal tax, surtax, and excess profits tax rates, the present system leaves the corporation with large excess profits better off than the corporation with small excess profits, compared with their relative situation under the 1940 law. Under that law, as total profits increased (once the corporation had already passed into the excess profits zone), the normal tax and surtax took part of the increase and the excess profits tax took part of the rest of the increase. Now, the only thing that happens is that the excess profits tax takes part of the increase. In other words, under a given set of rates, the present system imposes a lower combined marginal rate (even disregarding the 80% limitation).

The change in 1941 tended to make the base-period alternative less attractive, since base-period income taxes were imposed at lower rates than the wartime normal tax and surtax, but there is no indication that the change was made deliberately to increase the relative importance of the invested-capital method.

Summary. The concept of excess profits in the present law, partly explicit and partly implicit, seems to be something like this: excess profits are the excess of the average annual profits of a business corporation during the years 1940-19— over 89% of the annual average profits that would have been realized in the three best years of the period 1936-1939 (or 95% of the four-year average) by the corporation in question if its reasonably assured potentialities, as of January 1, 1940, had been allowed full expression during that time, free of rarely occurring unfortunate episodes, physical or economic, and if the general business background had been happy enough to permit a return of at least 5% to 8% on the capital put into the business, including half the borrowed capital.

[24] *The Revenue Bill of 1941*, H. R. REP. No. 1040, 77th Cong., 2d Sess. (1941) 24.

This definition, long and awkward though it is, obviously slurs over or omits considerations that would be important if the tax were to have a long life ahead of it. But there seems to be little tendency anywhere to assume that it will. For one thing, as the analysis above has indicated, the workmanship that has been lavished on the law and regulations has been concentrated on the features that are more significant for a temporary tax that carries a very high rate. And this kind of effort, requiring as it does a continual straining to provide for a hundred and one special cases where the tax rate might otherwise prove destructive, has been so exhausting to the research staffs, the bill drafters, the Congressional committees, and the taxpayers and their representatives that the repeal of the excess profits tax could, on the whole, bring as its immediate reaction only a sense of relief. Under a much lower rate, with effort devoted to refining the standards that would be applicable over a long period of time, an excess profits tax might conceivably become a permanent part of the federal revenue system. But this is not the kind of tax that Congress wanted for war, and there is as yet no indication that Congress wants it for peace.

SECTION 722: SAFETY VALVE OF THE EXCESS PROFITS TAX

THOMAS TARLEAU*

Designed to serve as the safety valve of the excess profits tax—the taxpayers' escape from the otherwise inflexible yardstick of normal earnings measured by the 1936-1939 base period or a stated return on invested capital—Section 722 discloses by its very provisions the essential weaknesses of that tax. The excess profits tax was originally conceived by the Treasury Department as a levy upon all profits in excess of a fair return upon a corporation's invested capital. While an excess profits tax law has been enacted only during periods when this country has been at war, its potentialities have not been limited to the taxation of "war-profits" alone. Its possibilities as a permanent and integral part of our system of taxation were not ignored. However, it is now quite clear that the Treasury has finally abandoned any hope the Congress will make the excess profits tax anything more than a temporary levy, designed to recapture excessive profits traceable to an inflated war economy.

It may be urged with some merit that the tax as now designed does not fully or properly achieve its purposes and that it is neither a good excess profits tax nor a sound war profits tax. A corporation with an inflated capital may be permitted a credit in excess of a normal return on its original investment. Another corporation having had unusually large profits during the base period because of a temporary windfall or a fortunate monopoly, may be allowed to retain much of its income which theoretically falls within the category of war profits. Situations such as these exist only because of the conflict of purpose inherent in the present excess profits tax. If it was intended as an "excess profits" tax, a credit based on invested capital alone should be proper, and a comparison with a period of normal earnings would be immaterial. If the tax is intended to reach "war profits," consideration of the taxpayer's invested capital is not material and the excess above those profits attained in a normal period should be the sole criterion. Since the latter seems to be the sole purpose of the present excess profits law, there would seem to be much justification for the elimination of the invested capital credit, particularly in view of the expanded relief provisions of the Revenue Act of 1942.

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In any event, the law now offers credits, of equal rank and dignity, based on both invested capital and normal earnings. In substance, however, the invested capital serves merely as one of a number of relief provisions accorded to corporations having an inadequate earnings base or to those not in existence during the base years. Section 722 is intended to function in those cases where the use of the invested capital credit and the application of the other relief provisions still leave subject to the excess profits tax an amount of income which cannot fairly be called excess profits. The remedy afforded by Section 722 is an enlargement of the average earnings credit, or in certain cases the creation of one where none had previously existed, in order that an equitable comparison between normal earnings and earnings during an excess profits tax period might be obtained.

Section 722 provides that in any case in which the taxpayer establishes that the excess profits tax, without the benefit of the relief therein provided, would result in an excessive or discriminatory tax, *and also* establishes what would be a fair and just amount representing normal earnings to be used as a constructive average base period net income for the purpose of an excess profits tax based on a comparison of normal earnings and earnings during an excess profits tax period, the tax shall be determined by using such constructive average base period net income. It is further provided that in determining the basis of such constructive base period net income, no regard shall be had to events or conditions affecting the taxpayer, the industry of which it is a member, or taxpayers generally, occurring or existing after December 31, 1939, with certain specified exceptions which will be referred to later.

Subsection (b) of Section 722 provides that the tax shall be considered excessive and discriminatory, in the case of a taxpayer entitled to use the average earnings method pursuant to Section 713, if its base period net income is an inadequate standard of normal earnings because of some factor appearing in one or more of its five specified subdivisions which will be considered below.

SUBSECTION (b)(1)

"in one or more taxable years in the base period normal production, output, or operation was interrupted or diminished because of the occurrence, either immediately prior to or during the base period, of events unusual and peculiar in the experience of such taxpayer,"

This subdivision is concerned primarily, as the report of the Senate Finance Committee indicates, with an interruption or diminution of production occasioned by an event of a physical character which is unusual and peculiar in the experience of the taxpayer, *i.e.,* fire, flood, hurricane, strikes, etc.

One of the troublesome questions presented by this subdivision is the interpretation of the phrase "immediately prior . . . during the base period" which language we find repeated under Subsection (b)(4). Obviously, it was intended that some flexibility be permitted in applying this clause and that no definite limitation of time be imposed. The legislative purpose may be gathered from the explanation contained in the regulations: that "an event is deemed to occur immediately prior

to the base period if under normal circumstances the effect of such event would not be fully manifested until a year in the base period and such effect is directly related to such occurrence." Thus it becomes apparent that "immediately prior" does not so much relate to a period of time as it does to the requirement that there be a close causal connection between the prior event and the abnormality experienced some time during the base period years. In contrast to Subsection (b)(4), it is difficult to assume a situation within the purview of this subdivision which would be likely to manifest itself within the base period unless it had occurred within a comparatively short time prior to the commencement of such period. Yet, in theory, the time element is not of itself controlling, and the right to relief is predicated upon the showing of a reduced production directly traceable to such prior event, unusual and peculiar in the taxpayer's experience.

There are few taxpayers for whom the occurrence of an event of the character contemplated by this subdivision would be anything but unusual and peculiar. Yet, there are some corporations whose operations are periodically interrupted or diminished by such circumstances and which have had periods of prosperity despite the regular happening of these events. The regulations cite the example of a logging corporation whose operations are annually interrupted by spring floods occasioned by thaws and rains. Another example may be found in the decision of the Board of Tax Appeals in the case of *Delaware Terminal Corporation v. Commissioner.*[1] The Board, in its findings of fact in this decision, stated that the barber shop industry in the City of New York was subjected to an annual spring strike. Without commenting upon the correctness of that finding, and assuming for the purpose of illustration that a strike can be deemed to be a regular and normal occurrence in this or any other industry, it can be seen that an interruption of business under those circumstances will not in fact reduce the taxpayer's normal earnings. To permit a reconstruction of the period so affected would increase an otherwise normal period of earnings.

It should be remembered that the reference to the base period normal production which is the subject of interruption or diminution connotes normal production or earnings in the year thus depressed and does not necessitate a comparison with any other period of actual normal earnings. Thus, even though a given taxpayer's normal earnings may be said to be approximately $50,000 per annum, if during one of the base years its earnings would have amounted to $100,000, had its production not been interrupted by flood, it would be entitled to a reconstruction of its earnings for that year upon the level of $100,000. The regulations permit the reconstruction of a base period year on the level of operations which would actually have existed in that year, even though such a level is abnormally high for the year in question.

The measure of relief available under this subdivision is the allowance of an additional amount of income in the base period equivalent to the sum of increased

[1] 40 B.T.A. 1180 (1939).

earnings which the taxpayer would have had if the circumstances causing the interruption or diminution of business had not occurred. In reconstructing the disturbed period, consideration may be given to the taxpayer's production or level of operations in the unaffected portion of the base years. If the entire base period is subnormal, comparison may be made with a previous period of demonstrated normal earnings in the taxpayer's business experience or with a comparable competitor or the industry of which the taxpayer is a member. Under any of these methods of comparison, normal earnings must be determined in accordance with the factors of volume of sales, cost of operations, and other elements entering into the computation of net income, actually existing during the period which is being reconstructed.

SUBSECTION (b)(2)

"the business of the taxpayer was depressed in the base period because of temporary economic circumstances unusual in the case of such taxpayer or because of the fact that an industry of which such taxpayer was a member was depressed by reason of temporary economic events unusual in the case of such industry,"

Whereas the business-disturbing factor in the preceding subdivision is a physical abnormality, Subsection (b)(2) refers to an economic circumstance, temporary and unusual in character, which depressed the taxpayer's base years or served to depress the taxpayer's entire industry during that period. The requirement that this circumstance be unusual in the taxpayer's experience and temporary in nature limits the application of this subsection to those events which, as the regulations phrase it, have "little perceptible effect upon the long run prospects of a business" and thereby tends to exclude those corporations or industries which are normally, chronically or continually in a state of depressed earnings. In those cases a low earning level during the base period is not actually a subnormal condition. It is a proper standard of comparison for those taxpayers since it is representative of their normal earnings.

It is not possible to circumscribe the meaning of the word "temporary." It is subject to elastic interpretation, governed by the nature of the economic circumstance and the type of business affected rather than by the period of time the occurrence is in existence. The same elapsed time may in one case rightly be considered a temporary factor and in another a chronic condition. Ordinarily an event will be considered temporary if it is not usually encountered by the taxpayer or its industry and will have no permanent effect upon the corporation's future earnings.

The Act does not refer to the period in which the economic circumstance must occur. However, from the illustrations of typical economic circumstances contained in the report of the Senate Finance Committee it would seem that this circumstance may take place either during or before the base period. Thus, in the example there given of an industry engaged in a price war which resulted in a depressed base period for its member corporations, the economic disturbance occurs during the base period. In the case of the manufacturing corporation which conducts its business with a single customer and which, upon losing that customer, must of necessity

develop a new market, this subdivision should be applicable whether the loss of its customer occurred prior to or during the base period. It is true that the Senate Finance Committee, in citing the latter example, refers to the happening of this event during the base period and the regulations repeat the illustration verbatim. Nevertheless, it could not have been intended to limit the scope of this subdivision in this way. It would be entirely consistent with the purpose of Subsection (b)(2) to grant a taxpayer relief where the temporary economic circumstance occurs some time prior to the base period if the impact of such event is felt during the base period and causes a depressed earning level.

Thus, let us assume the case of a paper manufacturing corporation which had never had a sales department since it commenced business; its entire and substantial output was sold to an unrelated distributing company which in turn disposed of the product among thousands of its smaller customers. Several years prior to the base period the manufacturing corporation and its distributor terminated their sales contract and the manufacturer, being unable to acquire another distributor, was forced to develop its own sales outlet. If in this case the corporation could not normally have developed by 1936 the volume of sales which it had had prior to its parting with the distributing company, and the base years earnings were depressed as a direct result thereof, Section 722(b)(2) should be clearly applicable. It seems reasonable to allow relief under this subdivision if under normal circumstances the effect of the happening of such prior economic circumstance was not manifested until some time during the base period.

The frequent reference in the law and regulations to the taxpayer's "industry" requires an understanding of the limitations of that word as there employed. The regulations loosely define an industry as comprising "a group of enterprises engaged in producing or marketing the same or similar products or services under analogous conditions which are essentially different from those encountered by other enterprises." It will be seen that the group intended to be embraced within the term is not as large as that under the every-day conception of an industry. For example, the electrical products industry would probably be comprised of several industries, within the meaning of Section 722, the vacuum cleaner manufacturers, the electrical refrigerators manufacturers, the air-conditioning equipment manufacturers, etc. The fact that some of the larger corporations may manufacture more than one of these products does not alter the situation for they may well be classed as members of more than one industry. Certainly the factors which may materially affect the base period of the air-conditioning industry might have no influence upon the earnings of other classes of manufacturers in the electrical products group.

The method of establishing a constructive base period income under Subsection (b)(2) is similar to that employed under the previous subsection, that is, on the basis of profit factors existing during the base period. However, if the economic circumstance disturbs the prevailing profit factors its effect may be ignored. Thus,

if the economic circumstance relates to the labor market, causing unusual and excessive pay rates, in reconstructing the cost of operations for the disturbed period, the excessive charges may be eliminated and normal salary schedules substituted. If the economic circumstance depresses the earnings of the taxpayer without affecting the taxpayer's industry, reconstruction of the base period may be effected either on the basis of the level of operations and earnings in other parts of the base period, or by reference to the average level in a prior period of normal earnings, or by comparison with earnings of comparable competitors or the taxpayer's industry as a whole. If the taxpayer's industry has been affected, the reconstructed period may be established either by reference to the taxpayer's earnings experience in normal parts of the base period, by reference to a prior period of moderate earnings, or by comparison with the base period experience of comparable corporations or industries.

SUBSECTION (b)(3)

"the business of the taxpayer was depressed in the base period by reason of conditions generally prevailing in an industry of which the taxpayer was a member, subjecting such taxpayer to

"(A) a profits cycle differing materially in length and amplitude from the general business cycle, or

"(B) sporadic and intermittent periods of high production and profits, and such periods are inadequately represented in the base period,"

In drafting the Excess Profits Tax of 1940 and its relief provisions, Congress made no allowance for the possibility that the base years of 1936-1939 might for some industries be a period of subnormal earnings. The corporate taxpayer employing the average earnings credit could use only the base years selected since no provision was made for a more equitable base period in the case of those classes of taxpayers whose earning experience did not conform with the experience of business in general. The 1942 amendment of Section 722 under Subsection (b)(3) will afford substantial relief for corporations which are members of an industry whose recurring periods of normal profits are at variance with the average business profits cycle and those corporations whose irregular pattern of profits are not adequately represented in the base period years.

Subdivision (A) of Subsection (b)(3) deals with the problem of the variant profit cycle—a type which does not conform with the general business cycle. There are undoubtedly many industries whose earning patterns do not normally and regularly parallel the experience of American business in general. If the profit cycle of one of these industries were to be superimposed upon a cycle representative of general business they would not regularly coincide and, consequently, their years of profits or losses, normal or subnormal earnings, would not occur at the same time. Accordingly, the taxpayers which compose such an industry may, as a result of this variance, have experienced a period of subnormal earnings during the base

years of 1936 to 1939. Their base period earnings, therefore, would be an inadequate standard of normal earnings, an inequity which this section attempts to correct.

The Act requires that the profit cycle of the taxpayer and its industry differ materially "in length and amplitude" from the general business cycle. If these conditions exist there will be a decided variance between the two cycles. However, there are many other conceivable situations, where relief was clearly intended under this subsection, which will not satisfy the test of a difference in both length and amplitude. Nevertheless, the taxpayer in each of these cases may not have had average normal earnings during the base period years solely because it was in the trough of its earning cycle during all or part of that period. The fact that either the length or the amplitude of the taxpayer's cycle happens to conform with the general business cycle should be of little consequence in the determination of its right to relief.

The Treasury Department, apparently desiring to avoid the confusion likely to result from the strict interpretation of the subsection, has phrased its regulation so as to nullify the necessity for proof of a variance in length and amplitude. The regulations state that a profit cycle shall be deemed to differ in length and amplitude if the taxpayer's period of normal profits has not occurred during the base period but at some prior time entirely or partly without the base period and, further, that it is not necessary that the crests and troughs vary from the level of high and low profits of the general business cycle. Therefore, despite the statute's express requisite, if the base period is not a time of normal earnings because of a profit cycle which does not conform with the normal pattern of industry in general, and even though the length and amplitude of the cycle does not vary from that of general business, Subsection (b)(3) will be considered applicable.

The taxpayer and its industry must be able to show a history of earnings which fluctuated with some regularity in accordance with certain recurring economic causes. That is, to quote the regulation, its business experience must be "susceptible of segregation into a cyclical pattern." This does not mean that the taxpayer and its industry must have had, prior to the base period, an earnings experience which has gone through a series of complete cycles, which, within the common meaning of the word "cycle," recurred and repeated itself at regular intervals. Such a construction would preclude many taxpayers, otherwise qualified, whose business experience, or that of its industry, is of relatively short duration or those whose cycles require a great many years for completion. If the conditions which cause the fluctuation of earnings necessary for a cycle pattern have previously prevailed in the history of such an industry and may be expected under normal conditions to result in periodic and substantial changes in the level of earnings, the earnings experience is cyclical in form. It would seem entirely possible to prove a corporation's earnings susceptible of cyclical segregation even though it has not yet gone through the complete revolution of a single cycle.

There are certain industries whose earning cycles vary from that of industry in general because their periods of normal earnings primarily depend upon years of general business prosperity. Such industries, as exemplified by the manufacturers and retailers of various luxury items, exhibit a tendency to lag behind the general business cycle. Such items are not widely purchased until the consuming public feels able to afford them. The wage earner is not conscious of prosperity until better business conditions permit his employer to increase his salary—the stockholder, when corporate earnings warrant the declaration of increased dividends. Accordingly, these industries do not attain a period of normal earnings until the general business cycle is well advanced, and may be expected to continue having normal earnings after the general business cycle has begun its decline from normal. Under such circumstances, these industries will have part of their period of normal earnings within the base period years and part without, a situation indicative of a variant profit cycle.

A taxpayer does not qualify as a variant cycle case merely because its industry's and its own level of earnings were below the average earnings of industry in general during the base period years. The circumstances which caused its depressed earnings must be shown to be ordinary and usual for the taxpayer's industry in the sense that such factors have either previously appeared, or may be expected to appear, with some regularity in the industry's experience. If the circumstance responsible for the subnormal base period earnings is unusual and extraordinary in character, it would not tend to recur, but as an unusual economic circumstance it may provide a basis for relief under Subsection (b)(2).

The relief which is permissible under Subdivision (A) may be based upon comparisons with one or more prior periods of not less than three years duration in the taxpayer's experience, or in the experience of the taxpayer's industry, which can be shown to have been periods of normal earnings. The regulations suggest that if no such prior comparable periods are available, comparisons may be made with other taxpayers or industries of comparable financial size and type of product, for which the base period has been a period of normal earnings. It may be noted here that the Treasury's concession that a corporation otherwise entitled to relief under Section 72(b)(3)(A), may not have a prior comparative period of normal earnings would seem to lend much weight to the position heretofore taken that a taxpayer may be entitled to relief as a cycle case even though the taxpayer and its industry had not experienced a complete profit cycle.

The major restriction upon the choice of a prior period of normal earnings which is to serve as basis of comparison is that such a period must bear the same relationship to the profits cycle of the taxpayer and its industry as the base period bears to the general business cycle. Stated in another way, since the base period years of 1936 to 1939, established as a period of normal earnings, had in fact a higher earnings level than the average of prior earnings of business in general, the

comparative period selected by the taxpayer may show the same proportionate increase over the profit cycle of the taxpayer and its industry, but may not exceed it. Thus, if it may be concluded that the base period earnings level is approximately 20% higher than the average earnings of the general business cycle, the selected "normal" period may not be more than 20% better than the taxpayer's and its industry's average earning experience.

Subdivision (B) of Subsection (b)(3) covers the situation of sporadic and intermittent peaks of profits which are inadequately represented in the base period. In a sense this is an unusual type of cycle, a class of irregular and variable cycle in which the sporadic and unusually high profit years are caused by circumstances beyond the control of the taxpayer. However, the Treasury does not consider this a true cycle case because of its irregular and unpredictable pattern. In fact, the regulations indicate that this subdivision is distinguishable from (A) in that the taxpayer's earnings experience hereunder is not capable of cyclical segregation.

These years of unusually high production and earnings, although uncertain and unpredictable as to their time of occurrence, are, on the average, part of the normal earnings pattern of this type of corporation. The level of earnings necessary to sustain this taxpayer is predicated upon the high profits recurring in these peak years. If such years did not appear from time to time, its otherwise low rate of profits would make such business unprofitable. Therefore, if during the 1936 to 1939 period this taxpayer did not have one of its peak years, the base period would not on the average reflect normal earnings. Obviously, in order to sustain a claim hereunder, it must be shown that the base years were in fact a period of subnormal earnings. Otherwise, the base period would be an adequate standard of comparison even though the peak profit years are not represented therein. It is not sufficient for a taxpayer to show that upon certain prior occasions its earnings reached unusually high levels. It is only where these recurring peak years are entirely normal in the experience of the taxpayer and its industry and are the result of definite factors peculiar to that industry that this subdivision is intended to apply.

Since Subsection (3) refers generally to a depressed base period resulting from conditions prevailing in the taxpayer's industry, it is a requisite under (3)(B) that the entire industry be subject to such irregular pattern of earnings. While it was undoubtedly intended to afford relief to this type of corporation even if its earnings experience does not conform to that of its industry, such a taxpayer would probably have to qualify under Subsection (b)(5).

The report of the Senate Finance Committee suggests the fruit canning industry as a possible example of the situation governed by this subdivision. In that industry profits are dependent upon the fortuitous combination of a good crop and a firm market. Other canning industries, such as farm produce, salmon and tuna fish packing, may well have earning records typical of this situation. Certain apparel

industries, with products for which the demand is subject to the unpredictable dictates of fashion, are also possible examples.

The method of reconstructing the base period is in most respects similar to that under (3)(A). The taxpayer may reconstruct upon the basis of a prior period which is demonstrated to be more representative of normal earnings. Or, in a proper case, normal earnings may be determined by employing the average of the taxpayer's earnings for its entire business experience prior to January 1, 1940. The latter method offers the simplest and most precise formula for reconstructing a base period to be found in the regulations governing this section. The regulations fail to disclose under what circumstances a taxpayer may properly employ this method. It must be assumed that the taxpayer's right to use it will depend upon whether the average of its past earnings are a reasonable reflection of normal earnings.

SUBSECTION (b)(4)

"the taxpayer, either during or immediately prior to the base period, commenced business or changed the character of the business and the average base period net income does not reflect the normal operation for the entire base period of the business. If the business of the taxpayer did not reach, by the end of the base period, the earning level which it would have reached if the taxpayer had commenced business or made the change in the character of the business two years before it did so, it shall be deemed to have commenced the business or made the change at such earlier time. For the purposes of this subparagraph, the term "change in the character of the business" includes a change in the operation or management of the business, a difference in the products or services furnished, a difference in the capacity for production or operation, a difference in the ratio of nonborrowed capital to total capital, and the acquisition before January 1, 1940, of all or part of the assets of a competitor, with the result that the competition of such competitor was eliminated or diminished. Any change in the capacity for production or operation of the business consummated during any taxable year ending after December 31, 1939, as a result of a course of action to which the taxpayer was committed prior to January 1, 1940, or any acquisition before May 31, 1941, from a competitor engaged in the dissemination of information through the public press, of substantially all the assets of such competitor employed in such business with the result that competition between the taxpayer and the competitor existing before January 1, 1940, was eliminated, shall be deemed to be a change on December 31, 1939, in the character of the business."

Measured by the number of taxpayers whose applications for relief are likely to be governed by it, this is probably the most important subsection of Section 722. The great mass of corporations first coming into existence during the years 1936 to 1939 and the even greater group of taxpayers which during that period in some way changed the character of their operations or the nature of their products, fall within the purview of this subsection. If, because of such commencement or change in the character of its business during or immediately prior to the base period, a taxpayer's net income for those years is an inadequate reflection of its normal operations for the entire period, an adjustment or theoretical reconstruction of its base years will be permitted in accordance with the concept of normal operations.

The subsection, elaborating upon its intended scope, sets forth these situations which will be considered to have been a change in the character of business: (1) a change in operations or management, (2) a difference in products or services, (3) an increase in the capacity of production, (4) a difference in the ratio of non-borrowed capital to total capital and, (5) the acquisition before January 1, 1940 of the assets of a competitor, thus reducing or eliminating competition. The first classification has been added to the law by the 1942 amendment to the section, the others are restatements of previously existing bases for relief. Not every change in management or in the method of operations, whether substantial or otherwise, will of itself satisfy the requirements of the section. Where, however, such a change does result in a substantial increase in the corporation's earnings, whether by reason of a more aggressive management or sales force, an increase in its expenditures for advertising or a change in its major advertising medium, an increase in the efficiency of its manufacturing operations resulting in decreased costs, a radical improvement in the quality of its existing products, or because of any other factor traceable to such change, the taxpayer is entitled to have the effect of such a change extended to its operations in the entire base period.

The requirement that the commencement of business or change in its character occur during or immediately prior to the base period is subject to the same explanation as that offered above under Subdivision (b)(1). If the effect of such a change manifests itself at some time during the base period, it will be deemed to have taken place immediately prior thereto without regard to the length of the intervening period. It may normally be expected that some time will elapse between the inauguration of a new business or the occurrence of some change in character before the attainment of normal operations or earnings. The time-lag or delay in reaching a normal level may in many instances under this subsection be substantial. Nevertheless, this circumstance will not serve to disqualify a taxpayer if its level of normal earnings could not ordinarily have been attained prior to the base period.

Express provision is made for the corporation which did not reach by the end of the base period the earning level it would have reached had it commenced business or had a change in character two years prior to the actual date thereof. In those cases the commencement or change is deemed to have taken place two years prior to the date of the occurrence. This provision is intended to apply to corporations which, as a result of such commencement or change, were in the process of growth or expansion during all or part of the base period. The Senate Finance Committee viewed it as an opportunity afforded growing corporations to establish within a period of normal earnings a larger earning capacity attributable to the theoretical two year earlier commencement or change. To qualify as a "growth" corporation its record of earnings must indicate a steady rate of growth during the base period and, if in actual existence at that time, immediately prior to the base years. How-

ever, in the determination of growth or expansion, no consideration may be given to events occurring or existing after December 31, 1939.

The extent of the relief available to taxpayers in a period of growth during the base years is measured in one of two ways. If the taxpayer's business *actually reached* the level of earnings by the end of the base period which it would have reached had its commencement or change in the character of business occurred two years prior to the date thereof, its base years may be reconstructed upon the level of operations actually attained. In this case the taxpayer's earning level would not be increased as a result of a theoretical two year "pushback." The level attained by the end of the base period will be considered its normal earnings capacity and no regard will be had for any increase in that level subsequent to its base years. This taxpayer's entire base period, notwithstanding that it was not in existence throughout the base period, may be reconstructed upon the basis of the character, nature and size of the business actually developed prior to January 1, 1940. The regulations suggest that this does not necessarily mean that the highest level of earnings actually or constructively attained should be ascribed to the entire base period. The earnings of a business would naturally tend to fluctuate to some extent during each of the base period years in accordance with the variations in sales, production costs and other factors entering into the determination of profits in each of those years.

If, on the other hand, the taxpayer's business did not reach by the end of the base period the level of earnings it would have reached had the commencement or change in character of business occurred two years prior to the actual date thereof, its base years may be reconstructed upon the hypothetical level of earnings which would have been attained by it if that event had in fact occurred two years earlier. The regulations state that in such a case the constructive average base period net income may depend upon reconstructed, as opposed to actual, production, costs, demand, sales and selling prices. Thus, in the determination of constructive normal earnings for the base years, consideration may be given to estimates of these factors based upon the earlier commencement and to comparisons with similar taxpayers or the industry of which the taxpayer is a member. Of necessity, the base period income thus reconstructed must depend in some degree upon speculation and conjecture.

It should be noted, however, that the constructive average base period net income which is used in computing the tax in the first and second excess profits tax taxable year must be based upon the actual earning capacity which the taxpayer could reasonably have expected to reach during those two years. Otherwise the constructive amount of normal earnings based upon a two year push-back may be founded upon a productive capacity which accedes the capacity attainable in those excess profits tax taxable years and would thereby constitute an improper standard of normal earnings for those years. In effect, therefore, the reconstruction of normal earnings used in determining the excess profits tax in any year must not be based upon a capacity greater than that which would have been available in any such taxable year.

Is the taxpayer which commenced its business, or had a change in the character of its business, during or immediately prior to the base period, and whose base period net income does not adequately reflect normal operations for the entire period, limited in the reconstruction of its base period net income by the earning level which it would have attained had it commenced business or had its change in character two years prior to the actual event thereof?

It was the intention of Congress to permit a taxpayer in any case where it could be demonstrated that its excess profits tax was discriminatory or excessive within the meaning of Section 722(b), to establish what would be a fair and just amount representing its normal earnings during the base period years and to permit the use of a constructive average base period net income predicated upon such an amount. Any interpretation of the law which prevents a taxpayer from proving the amount of its normal base period earnings or to limit the amount thereof to be assigned to its constructive base period net income must be considered erroneous because it is contrary to that intention.

The first sentence of Subsection (b)(4) relates to the situation where base period net income, because of the commencement or change in character of the business, does not reflect *normal operations.* The second sentence refers only to growing corporations which did not reach the *earning level* they would have reached had such events occurred two years earlier. These sentences do not by any means deal with the same problems. They might properly have been made separate subdivisions of 722(b).

For example, take the case of a corporation engaged in the business of growing hemp, which commenced operations in 1936. Its first planting is made in that year followed by other plantings in succeeding years. Since hemp takes seven years to mature, this taxpayer could not be expected to have any earnings until 1943. Here the taxpayer did not reach a level of normal operations and fits precisely within the first sentence of Subsection (b)(4). However, if its only measure of relief is to be based upon a reconstruction of the base period net income based upon a two year prior commencement of its operations, no relief is in fact available to it. This taxpayer has not attained any earnings level at all during the base period and was not then in the process of growth. Therefore, even with the two-year push-back it would not attain any level of earnings, normal or otherwise.

Unfortunately, the regulations governing Subsection (b)(4) do not provide illustrations of the methods of establishing normal earnings for cases other than those in the class of growing corporations. Nor, for that matter, is any reference made therein to corporations eligible for relief under this subdivision which do not fall into that category. It must be presumed that this was an oversight rather than a determination to deny a fair and just amount representing normal earnings to those taxpayers whose base period net income does not reflect normal operations of the business.

A change in the capacity of production or operation which was consummated subsequent to the base period years, if such change is the result of a course of action to which a taxpayer was committed prior to January 1, 1940, is deemed to be a change in the character of business occurring on December 31, 1939. Competent evidence of any form may be offered as proof of the taxpayer's commitment to a course of action. The fact may be evidenced by a contract, the expenditure of money, the placement of an order, or any other change in position indicative of the taxpayer's intention to make such a change. However, since the change in the character of business attributable to December 31, 1939 will actually have been consummated after that date, the results or effects of such a change may not be reflected at all in the business of the taxpayer during an excess profits tax taxable year prior to the utilization of such change, or only partially reflected in a year in which the change has been partly utilized in the business.

Thus, if a taxpayer makes a commitment in 1939 for an increase in the capacity of its plant and the work involved is not completed until June 1, 1941, its constructive average base period net income used in determining its excess profits tax for 1940 may not reflect the increased capacity; for the taxable year 1941, one-half of such increased capacity may be considered in establishing constructive net income. If in this example the increased capacity had been partially completed in 1940 and that part had been placed in operation and utilized in the taxpayer's business, the increased production may be reflected in the determination of normal earnings to the extent thus utilized.

Generally the constructive average base period net income is determined by reference to a level of full normal capacity as of December 31, 1939, which, pursuant to the provisions of this subdivision, is deemed to include the increased capacity for which the taxpayer was committed prior to that date. For any taxable year subsequent to a year in which such change has been completed and utilized in the taxpayer's business, the constructive average base period net income may reflect the entire increase in capacity, regardless of whether the increased capacity was actually utilized in the business of that year.

While it is a basic principle of Section 722 that no regard may be had of events or conditions affecting the taxpayer, comparable taxpayers, or the industry of which it is a member, occurring after December 31, 1939 as an indication of normal earnings, the force of that rule is relaxed in the case of taxpayers subject to the commitments here discussed. Although actual earnings after that date may not be offered as criteria of normal earnings, the extent to which the change in capacity after December 31, 1939 has increased the taxpayer's previous capacity of production may be taken into account. Accordingly, in establishing constructive base period net income, normal earnings may be indicated by use of the ratio between earnings in the taxable year attributable solely to the increased facilities and earnings from capacity previously available, the percentage of increased earnings thus determined

may be applied to the base year earnings as an indication of the level which would have been normal for that period.

It is not intended that a taxpayer have the benefit of a duplication of an excess profits credit afforded by some other section of the law. Thus, if the amount of money disbursed in an excess profits tax taxable year for the acquisition of such increased capacity constitutes a capital addition, for which the taxpayer is granted a credit under Section 713(a)(1)(B) equivalent to 8% of such addition, the constructive average base period net income attributable to the changed capacity must be reduced in that taxable year by the amount of the 8% credit.

SUBSECTION (b)(5)

"of any other factor affecting the taxpayer's business which may reasonably be considered as resulting in an inadequate standard of normal earnings during the base period and the application of this section to the taxpayer would not be inconsistent with the principles underlying the provisions of this subsection, and with the conditions and limitations enumerated therein."

It would not have been feasible to have enumerated in the Internal Revenue Code every variety of situation which would give rise to an excessive and discriminatory tax. Subsection (b)(5), commonly referred to as the "catch-all" provision, was the practical solution. Its purpose is to grant relief to taxpayers whose base period years are depressed because of any other factor not specifically enumerated therein where such a claim would not be inconsistent with the basic principles underlying Section 722.

The Senate Finance Committee report offers, as an illustration of this subsection, the case of a whiskey manufacturer commencing business in 1935 whose entire stock was in the process of being aged during the base period. Having no salable product available during the base years, its earnings could be expected to be subnormal, if not nonexistent, during those years. The similarity of this illustration to that of the hemp growing corporation previously discussed under Subsection (b)(4) is immediately apparent. The only distinguishing factor is that the hemp growing corporation commenced business during the base period while the whiskey corporation was organized in 1935, an immaterial distinction inasmuch as the commencement in 1935 clearly falls within the definition of "immediately prior" to the base period.

The extent of the Committee's confusion in its use of this example may be gauged by the fact that the same example was employed by it as illustrative of a typical (b)(4) situation in its "summary of principal changes" preceding the text of its report. Its report further confuses the situation by suggesting that such a case might qualify under (b)(2) were it not for the fact that "it might be said that the business was not depressed during the base period since it was operating at full manufacturing capacity." No explanation is given of why the Senate Finance Com-

mittee did not consider that this case meets all the requirements of Subdivision (b)(4).

The regulations relating to Subsection (b)(5) do not suggest the method of determining a constructive base period net income for taxpayers eligible thereunder. The reason for this omission is understandable. It may be expected that most cases which qualify under (b)(5) will, from a factual standpoint, be similar in many respects to situations governed by one of the first four subsections. They will find themselves within the catch-all provision because, while entitled to relief in principle, they do not satisfy the conditions of any one of the previous subsections. It is undoubtedly the intention of the Treasury Department, although unexpressed, that the general method of establishing normal earnings as suggested for the subsection nearest in principle to the case qualifying under (b)(5) shall be considered applicable.

SECTION 722(c)

Corporations which have not been in actual or constructive existence during any part of the base period are not entitled to use an excess profits credit based upon average earnings pursuant to Section 713. Generally, the credit available to them is based upon a stated percentage of their invested capital. Heretofore such newly incorporated businesses were not granted any form of relief even where the insufficiency of the credit so computed resulted in an excess profits tax which was patently excessive and discriminatory.

Section 722(c) is designed to offer relief to such corporation, upon proof of the excessiveness of its tax, and permits the use of an excess profits credit based on income. The excess profits tax, computed without regard to this section, will be deemed excessive and discriminatory if the invested capital credit of such taxpayers is an inadequate standard of determining excess profits because:

(1) the business of the taxpayer is of a class in which intangible assets not includible in invested capital under Section 718 make important contributions to income,

(2) the business of the taxpayer is of a class in which capital is not an important income-producing factor, or

(3) the invested capital of the taxpayer is abnormally low.

The first clause of Section 722(c) may be illustrated by a corporation, organized in 1940, whose level of earnings is dependent upon the number of contacts it makes in the industry which it services or supplies, rather than upon its small invested capital. Since its most important asset, the good will which it has established in the trade, is not reflected in its invested capital, the corporation is entitled to relief. The second class of taxpayers is the group in which invested capital does not play a vital role in producing income. The regulations suggest the example of a corporation doing business as fashion consultants which is not able to qualify as a personal service corporation under Section 725 because it has a large staff of technical and professional assistants. The final clause relates to a taxpayer engaged in a business

in which invested capital is normally substantial, but where, because of some factor peculiar in its case, its invested capital is abnormally low. A corporation which leases all of its manufacturing facilities, or sub-contracts the major part of its production, may be a fair example of this situation. If its invested capital is established to be abnormally low in relation to the size of its business, it should be able to qualify under Section 722(c).

The inadequacy of a credit based upon invested capital in such cases is obvious. However, the fundamental difficulty of establishing a reasonable substitute basis may be considerable. The law provides that taxpayers qualifying hereunder shall be entitled to use an excess profits credit based on income, using a constructive average base period net income determined in the same manner as that provided for taxpayers eligible under 722(b). These taxpayers have not had any earning experience in the base period years and consideration may not be given to the actual level of earnings attained thereafter. Therefore, hypothetical normal earnings for the base period may only be approximated through the use of comparatives.

Initially, the taxpayer is required to offer proof of the essential similarity of the competitors which it seeks to use as comparatives. For this purpose the requirement that no regard may be had to events or conditions affecting the taxpayer occurring after December 31, 1939 must of necessity be relaxed. The similarity may be established by a comparison of the taxpayer's profits and sales in the period subsequent to its commencement of operations with those of such comparable concerns during the same period. The existing relationship between the character and experience of each of their managements, the nature of the competition offered and any other factor material to the determination of normal earnings must be considered. The taxpayer may then reconstruct its base period net income upon the basis of the established relationship with such competitor's sales and earnings during the base years. The regulations suggest, however, that it may not be necessary to reconstruct each year in the 1936-1939 base period and that the average of such reconstructed normal earnings may be used.

RELATIONSHIP OF OTHER RELIEF SECTIONS TO SECTION 722

It should be noted that the relief provisions of Section 722 do not in all cases preclude simultaneous resort to other relief sections of the law. The regulations state that a taxpayer may not as a matter of right, in determining its constructive average base period net income under Section 722, apply some other section, such as 713(e)(1) or 713(f). However, it asserts that such a procedure may be permissible in a proper case to the extent that such sections are not inconsistent with Section 722. While the regulations do not reveal what would constitute a proper case, it is reasonable to conclude that the practice will be considered proper where the combined application of the two sections will not result in a duplication of benefits.

Consider the case of a New England corporation which had an operating deficit in 1936 and which, in common with many other corporations in that locality, had its plant inundated by the hurricane and flood which struck that area in 1938. Its application for relief under Section 722(b)(1) may serve to eliminate the abnormal effect of the 1938 flood and return that year to normal. Nevertheless, it would be grossly inequitable to deny such a taxpayer the right to exclude the 1936 deficit from its computation pursuant to Section 713 and thereby place the taxpayer at a tax disadvantage with relation to its competitors. Similarly, if any year, other than the year of abnormality adjusted under Section 722, is less than 75% of the average of the other three years, it would appear proper to permit the use of Section 713(e)(1) in conjunction with Section 722.

However, where a corporation has established in accordance with the provision of one of the subsections of Section 722 that its entire base period is depressed, that section provides for the reconstruction of the income of each of those years upon the level of normal earnings. To permit such constructive earnings to be augmented by the formulae offered in Section 713(e) and (f) would be clearly inconsistent with the principles of Section 722, since the resulting credit will be based upon an amount in excess of normal earnings.

The same view may be taken of the question of whether a taxpayer's constructive base period net income may be determined by the application of more than one of the subsections of Section 722. A corporation may have been affected by a physical disturbance in 1936 and depressed by reason of some economic factor in 1938. There does not seem to be any reason why Subsections (b)(1) and (b)(2) may not both be relied upon to establish normal earnings for the base period years. On the other hand, once a base year or the entire base period has been reconstructed to reflect normal earnings in accordance with the provisions of the regulations governing one subsection, a taxpayer may not then rely upon another subsection to increase that figure to an amount in excess of normal earnings.

CONCLUSION

The liberalization of Section 722 by the Revenue Act of 1942 extends beyond the mere increase in the classes of taxpayers eligible for relief. The elimination of the prerequisite that an application under the section result in a tax saving of at least 10% will open the door for a large number of taxpayers, otherwise qualified, which have heretofore been denied the benefits of Section 722. The deletion of that provision thus permits the filing of an application under the section for a year in which a taxpayer has had no excess profits tax to pay. A resulting increase in the unused excess profits credit will present the taxpayer with a larger credit carry-over or carry-back with which to reduce the tax liability for a prior or subsequent taxable year. It should be pointed out that the application need not be filed until the year in which the credit is to be applied.

Despite the substantial relief that is afforded by Section 722, there still remain cases of actual hardship under the excess profits tax, which find no help in that section. The problem of growing corporations has been only partially met by the two-year growth provision. There will be many corporations whose natural growth would equitably entitle them to a much higher credit than is afforded by the law. The problem of the corporations formed since the base period is not satisfactorily solved by Section 722. Section 722(c) affords relief only to very few types of newly formed corporations, and the great body of new business is limited to the invested capital credit. A new and growing business is placed under a severe handicap when its earnings are limited to a fixed percentage of invested capital while its competitors may have a much higher credit, because of the benefits of base period experience. This treatment of new corporations would tend to foster a monopoly and stifle growth to an extent serious to the national economy, were it not for the fact that the amount of new business now being formed for other-than-war purposes is negligible.

Despite these deficiencies, Section 722 takes care of the more serious inequities that would otherwise arise under the excess profits tax. Its broad scope enables the Treasury and the Tax Court to so mitigate the hard and fast rules for determining the excess profits tax credit that in most instances no drastic hardship is caused by the confiscatory 90% excess profits tax rate. The extent to which the section will be effective in giving relief will depend, of course, upon its administration. Efficient administration will furthermore depend to a great extent upon the reasonableness and self-control of the taxpayers. The Bureau of Internal Revenue, already hard-pressed by additional duties and responsibilities thrust upon it by the program of war taxation, will be greatly hampered in its application of the section if it is swamped by a great volume of unreasonable and unfounded claims. Very often, the result of an avalanche of unreasonable petitions for relief is the creation of an unfavorable attitude toward even reasonable and fair claims. On the other hand, the Bureau of Internal Revenue, confronted as it is with a section which calls for the exercise of an unusual amount of judgment and discretion, must be prepared to be more bold and vigorous than administrative agencies usually are.

CORPORATE READJUSTMENTS AND THE EXCESS PROFITS CREDIT

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The readjustment of corporate structures abounds in excess profits tax consequences. The inheritance of an incorporated enterprise by a successor company, whether a new or pre-existing entity, and whether by merger or by sale of assets; the split-up of an enterprise into successor companies, or into a parent-subsidiary pattern; the amalgamation of separately incorporated businesses, or elements thereof having economic unity, via mergers, consolidations, and liquidations; and the readjustment of the capital structure exclusively within the existing corporation—these are transactions the excess profits tax implications of which have been given extensive legislative recognition. These implications will and, indeed, already have taken a ranking position in the tax world.

The problems are manifold, and they reach into virtually all phases of the excess profits tax. Among others, there are involved the availability of excess profits credits to the extent unused by one or more of the companies in other taxable years; the redistribution of equity invested capital among the several taxpayers as their number and relationships are disturbed; changes effected in the status of borrowed invested capital; the drawing together, without duplication, of the aggregate base period income experience reflected in the rearranged corporate family; the effect on aggregate excess profits net income as hitherto separate loss and profit operations are brought into balance; the effect of short taxable years as corporate existences are terminated; and the uncertain reach of the adjustment for inconsistency with positions previously taken by the predecessor companies.

In all these, the effect upon the excess profits credit, whether based on income or invested capital, is normally the dominant consideration. In addition, the task of analyzing the statute is most acute with respect to this phase of the problem. Accordingly, this article will attempt a discussion of the problem of the excess profits credit involved in such corporate readjustments; and will approach the problem through an analysis of the controlling legislation as to both types of credit, and the results achieved thereunder.

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I. The Invested Capital Credit

The effect of a corporate readjustment on invested capital may vary widely in terms of dollars of credit, depending on a number of crucial factors. The more important of these factors frequently are whether or not there occurs a "reorganization," for income tax purposes, within the limited and in many respects artificial definition in Section 112(g) of the Internal Revenue Code; whether the readjustment is effected within an existing and single technical corporate entity, or involves a newly-organized corporate vehicle, or a combination of one or more existing structures; to what extent "identity" between the reorganized and unreorganized entities prevails; the equity-debt relationship of the capital structure, and other characteristics of the securities involved; and whether the transaction effects an intercorporate liquidation or its equivalent.

The importance of many of these, when brought to light in the following discussion, will be seen as the mere capricious effect of cross-play between various provisions of the income and excess profits tax and, in a broader sense, of a legislative failure to draw together a basic and consistent concept of investment for purposes of the excess profits tax.

Before attempting an analysis of the provisions of the Internal Revenue Code dealing specifically with problems of corporate readjustment, it will be well to summarize the basic statutory concept of "invested capital" applicable to taxpayers in general, as laid down in Sections 718 and 719 of the Code.

General Rule of Sections 718 and 719

The invested capital credit is based on the total of the average daily amounts of "borrowed invested capital" and "equity invested capital." For present purposes, the former amount may be described merely as 50% of outstanding written or formal debt, as more fully detailed in Section 719. Subparagraphs (1), (2), and (4) of Section 718(a) contain the general rules as to equity invested capital in which we are most interested. They establish the following major elements of equity invested capital:

(1) "Money . . . paid in for stock, or as paid-in surplus, or as a contribution to capital."

(2) Property similarly paid in—"included in an amount equal to its basis (unadjusted) for determining loss on sale or exchange." If the property has been disposed of, the basis is determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the disposition was prior to March 1, 1913, the basis is taken at fair market value of the property when paid in, and if the unadjusted basis of the property is a substituted basis, such basis is to be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under Section 115(l) for determining earnings and profits.

(3) The accumulated earnings and profits as of the beginning of the taxable year.

It will thus be seen that, so far as Section 718 is concerned, the basic pattern for statutory "invested capital" is capital originally paid in, whether in the form of money or other property, plus accumulated earnings; and that for this purpose, property is frequently taken at its cost,[1] which will be either the property value when paid in or the value of the stock, if different.[2]

It will also be readily realized that (in addition to variable results depending upon whether the stock may be valued at other than the value of the property) a departure from value of the property when paid in will take place under Section 718 wherever for income tax purposes the basis of the property is determined by reference to the basis thereof in another's hands. The situations in which this may occur are so numerous as to raise a question as to which is the more general rule. They include, as to property still held, the following types of acquisitions:

(1) Transfers to a controlled corporation, within Sections 112(b)(5) and 113(a)(8)(A), including "boot" transactions, after December 31, 1920. (Transfers before that date, although of a similar nature, will be controlled by the rule of cost.)

(2) Property acquired as paid-in surplus or as a contribution to capital, after December 31, 1920, within Section 113(a)(8)(B). (Here property value controls if the acquisition is prior to that date.)

(3) Property paid in for stock after December 31, 1917 but *prior* to 1936 if—

(a) A 50% interest or control remained in the same persons, or any of them, within the meaning of Section 113(a)(7); *and* the property was *either*

(b) acquired at any time during such period pursuant to a "reorganization" within the meaning of Section 112(g) of the Code;[3] *or*

(c) acquired during 1934 or 1935 pursuant to a "reorganization" within the meaning of Section 112(g) of the Revenue Act of 1934;[4] *or*

(d) acquired prior to 1934 pursuant to a "reorganization" within the meaning of Section 112(i) of the Revenue Act of 1932 (whether or not the 1932 Act was then in force).[5]

(4) Property paid in for stock during the taxable year 1936, or a subsequent taxable year, if in connection with a "reorganization" within the meaning of Section 112(g) of the Code.[6] (Here the percentage of retained interest is not material to the basis provision.)

(5) Property acquired by a railroad corporation after December 31, 1939, or by a street, suburban, or interurban electric railway corporation after December 31, 1934, pursuant to a court order as a result of an insolvency reorganization.[7]

[1] The unadjusted basis for determining loss is normally cost. See INT. REV. CODE §113(a).

[2] The cost of property paid in for stock is the value of the stock, which in turn is, for the lack of better evidence, frequently determined by reference to the value of the property. When a discrepancy can be shown, however, the stock value controls. See Pierce Oil Corporation, 32 B.T.A. 403, 430 (1935).

[3] INT. REV. CODE §113(a)(7)(A).

[4] *Id.* §113(a)(16).

[5] *Id.* §113(a)(12).

[6] *Id.* §113(a)(7)(B).

[7] *Id.* §113(o)(20), (21).

The underlying details involved in determining to what extent a corporation's various and frequently numerous property acquisitions for stock, or as paid-in surplus or contributions to capital, fall within the foregoing assortment of categories is little short of amazing. Since the above material is set forth largely for purposes of background, such detailed problems cannot be here developed.[8] It may also be noted, however, that further wide variation is encountered with respect to portions of the property originally paid in but disposed of prior to the taxable year, in that the law as to basis in effect *in the year of disposition* is followed,[9] but without regard to March 1, 1913 value if such law makes reference to such value.[10] Moreover if under the above rules a carry-over basis is appropriate for invested capital purposes, such basis must be reconstructed for the period held by the predecessor taxpayer (or taxpayers, if the immediate transferor acquired the property on a transaction resulting in a carry-over basis) by adjusting only on the basis of *cost* at the inception of the basis chain, in accordance with Section 115(l). Finally, if the disposition occurred prior to March 1, 1913, the flat rule of property value when paid in is followed.

There is little, if any, rational justification for a statutory definition of invested capital made up of such a hodge-podge of "values." An explanation of why such an incredible base for the measurement of excess profits could be adopted probably lies to some extent in an obviously mistaken notion of simplicity. The statutory rules do not, as is popularly supposed, avoid the necessity for valuing property. In all cases cost or value is the point of departure in determining basis. The use of carry-over basis as a measure simply forces the point of valuation back to a remote point in the chain of ownership, where values are likely to be more difficult to prove. A further answer is found in the adherence, through inertia, to finespun and unrealistic concepts developed, refined, and limited for a wholly different tax purpose—a *temporal*, not a *qualitative* issue—*i.e.*, in which taxable year a realization of gain or loss should be recognized in computing income tax.

Whatever the merits of the foregoing rules, however, they are the point of departure from which the invested capital consequences of corporate readjustments are to be determined, as more specifically outlined in provisions designed exclusively for

[8] Consider, for example, the uncertain and overriding judicial principles involved in the tax concept of "reorganization" such as what is "continuity of interest," Helvering v. Minnesota Tea Co., 296 U. S. 378 (1935); LeTulle v. Scofield, 308 U. S. 415 (1940); Helvering v. Alabama Asphaltic Limestone Co., 315 U. S. 179 (1942); Helvering v. Southwest Consolidated Corp., 315 U. S. 194 (1942); or "germane to a business purpose," Gregory v. Helvering, 293 U. S. 465 (1935); or a "party to reorganization," Helvering v. Bashford, 302 U. S. 454 (1938); Groman v. Commissioner, 302 U. S. 82 (1937).

[9] Thus, for example, in 1928 an *80%* retained interest or control was necessary for the carry-over of basis upon a "reorganization." Rev. Act of 1928, §113(a)(7). Generally speaking, prior to 1917 there were no carry-over basis provisions, and prior to 1913 no tax provisions at all.

[10] Since 1934 the basis for determining loss has been cost. See INT. REV. CODE, §113(a), (14). Under the Rev. Acts of 1924 to 1932, however, such basis was the greater of cost or March 1, 1913 value. See, *e.g.*, Rev. Act of 1932, §113(a)(14). Prior to that period it was the lesser of the two, *i.e.*, after the 1916 Act. Compare the 1918 Act, §202(a) and Rev. Act of 1921, §202(b).

such readjustments. These special provisions may be divided into two broad categories dealing respectively with "exchanges" and "intercorporate liquidations."[11]

Exchanges—Section 760

Section 760 was added to the Code by Section 230(a) of the Revenue Act of 1942, and is applicable only to taxable years beginning after December 31, 1941—in the absence of election by the taxpayer under Section 230(d) of the Act to apply the new section in computing tax for all taxable years beginning after December 31, 1939. As a part of the same legislative plan, Section 229(b) of the 1942 Act makes pre-existing law on the subject of exchanges—Sections 750 and 751—inapplicable to any taxable years beginning after December 31, 1941.[12] The effect of the old and new provisions may conveniently be developed by comparison with each other.

The scope of Sections 750 and 751 is limited to transactions qualifying as an "exchange," which is defined (somewhat less briefly) as a transaction to which Section 112(b)(4) or 112(b)(5) (or similar provisions of prior laws) were applicable, or a transaction by which property was acquired as paid-in surplus or a contribution to capital after December 31, 1917. In contrast with this clumsy enumeration in Section 750 of eligible transactions, Section 760 has substituted a streamlined definition under which an "exchange" includes any transaction by which one corporation receives property from another corporation and the basis of the property received, for the purposes of Section 718(a), is determined by reference to the basis in the hands of the transferor.

These transactions have been previously described in the discussion of Section 718(a). They include the acquisitions by means of a "reorganization," transfers to a "controlled corporation," and capital contributions covered by Section 750, and extend beyond it in at least two respects: First, the addition of Sections 112(b)(9), 113(a)(20) and 113(a)(21) by Section 142 of the 1942 Act has resulted in a further type of transaction in which basis is carried over on a transfer of property between certain corporations, despite the fact that a new basis would have been determined under prior law. These provisions (previously mentioned) are confined, however, to the transfer of property in effecting the plan of reorganization of a railroad or electric railway company under bankruptcy and receivership laws pursuant to court direction. Second, Section 718(a)(2), as amended by the 1942 Act, applies the law in effect in the year of disposition, in the event property has previously been disposed of, in determining whether a carry-over basis resulted at the time of acquisition. This rule is not in effect under Section 750 with the result that, to use an example previously indicated, property acquired and disposed of prior to 1932 upon

[11] It should be here mentioned that throughout this article the writers have freely borrowed on several occasions from an earlier article, touching some phases of the subject, written by one of them. See Bryson, *The Excess Profits Tax Provisions of the Revenue Act of 1942* (1943) 91 U. OF PA. L. REV. 394. Thanks are extended to the University of Pennsylvania Law Review for this privilege.

[12] It may be also noted that §229(a) of the Rev. Act of 1942 repealed §752 (highest bracket amount) as of the date it was originally enacted.

a "reorganization" in which 50% but less than 80% interest or control was undisturbed, would fall within Section 760, but not Section 750.

It should also be noted once more that Section 218 of the 1942 Act amended Section 718(a)(2) of the Code, to provide that where the basis of property to be included in invested capital is a substituted basis, the adjustments with respect to the period before the property was paid in shall be those computed under Section 115(l) applicable to the determination of earnings and profits. Section 760(a)(2) provides that basis, for the purposes of Section 760, shall be determined in accordance with Section 718(a). As a result, the new rule as to adjustments is a part of Section 760, although not a part of Section 750.[13] This amendment corrects many situations where the adjustment to the basis for the period prior to the exchange, in the manner required by Section 113(b)(2), would produce an erroneous result. For example, the basis for inclusion of property in invested capital is ultimately founded on cost, but depreciation adjustments under Section 113(b)(2) would be computed on a higher March 1, 1913 value. The amendment contemplates that adjustment for depreciation in the prior period should be based on cost, which is the basis on which accumulated earnings and profits for excess profits tax purposes are computed.

It will thus be seen that property taken into equity invested capital at a carry-over basis under Section 718(a) also falls within Section 760, if transferred by a corporation, and in either case would be taken in at the same basis figure. So far, this is mere duplication. What, then, is the effect of Section 760?

As a matter of mechanics, Section 760 merely provides that the amount taken into invested capital under Section 718(a), by reason of the acquisition of property on a carry-over basis from another corporation, shall be reduced by the sum of (1) any liabilities of the transferor assumed on the exchange, or any liabilities to which the property so received was subject; (2) any liabilities (typically bonds) of the transferee constituting consideration for the property received; and (3) any money or other property (at fair market value) paid to the transferor. In addition, if the sum of these amounts exceeds the basis of the transferred assets, the excess is thereafter treated as a reduction in daily invested capital.

So much for the mechanics of Section 760. Its effects and functions are less apparent than the steps involved in its literal application. One of the principal functions of the section is to provide a rule of allocation in a situation where, on an "exchange," property is paid in to some extent for stock (or as paid-in surplus or a contribution to capital) and also in consideration of liabilities assumed or secured by the transferred property, cash or other property. As will be seen from the formula prescribed by the section, the property paid in on the exchange is first applied to these forms of consideration paid by the transferee, and only the remainder is allocable to the stock.

[13] Query whether the new rule would apply to past years if the application of §760 is elected, *i.e.*, are the changes in §718(a) thus also given retroactive effect?

A second effect, if not a function, of Section 760 relates to the excess profits treatment of earned surplus as opposed to capital or paid-in surplus. The former—accumulated earnings and profits—is included in equity invested capital, as explained above. However, a deficit in earnings is not so included, in the sense that the full amount of capital and paid-in surplus is recognized without diminution on account of operating losses. This is the so-called "deficit rule." If, however, the losses serve only to reduce an accumulation of earnings, such losses are reflected in invested capital from year to year, since only the net balance of earnings as of the opening of the taxable year is counted.

Section 760 does violence to both of these rules. For example, if the transferor on an exchange has a deficit, and transfers all its assets to the transferee in exchange solely for stock of the latter, it will be seen that the invested capital so transferred will be less, in the amount of the deficit, than that previously avaliable to the transferor. This is because the addition to the invested capital of the transferee will not exceed the basis of the transferred assets; and a portion of the assets has been lost—in the amount of the deficit—which was previously reflected in the invested capital of the transferor (or an equal amount of assets to which they have been converted). The vanished assets will not, of course, contribute to the invested capital of the transferee.[14]

On the other hand, if a surplus exists in the transferor, the transfer of all the assets on the exchange will not have the effect of "freezing" the surplus into "capital," for excess profits tax purposes, in the hands of the successor company—even though all the assets will now have been paid in for stock. Under the rule of *Commissioner v. Sansome*,[14a] the predecessor's earnings and profits become earnings and profits of the successor, and by adjustment under Section 718(b)(3) they are removed from the category of money or property paid in for stock. Therefore, they will continue to be eliminated from invested capital in the event of operating losses. In addition, such earnings and profits will be immediately eliminated, as a direct consequence of the reorganization, if the successor company has an earned deficit at the time of the reorganization in excess of such earnings.

A further function of Section 760 is to prevent, in a stringent manner, the reflection of unrealized asset appreciation in invested capital through the creation of funded debt against such value on an exchange; and in the absence of unrealized appreciation to work a conversion of equity invested capital to borrowed invested capital, and *vice versa,* where the debt ratio of the capital structure is shifted through the medium of a reorganization. Thus, if the predecessor company has an all equity structure, and a surplus, its invested capital will correspond, speaking roughly, to its net assets or the book value of its stock. If the net assets are transferred for a

[14] The reduction in assets may take the form of adjustments for depletion, depreciation, and amortization, as well as complete losses.

[14a] 60 F. (2d) 931 (C. C. A. 2d, 1931).

combination of bonds and stock of the successor, such assets will first be attributed to the new bonds and only the remainder will be treated as equity capital. The bonds will be recognized as borrowed capital, and the section will, quite properly, thus have redistributed the invested capital in light of the new debt-equity ratio of the enterprise.[15]

Conversely, if assets were acquired by the predecessor by using its bonds (or their proceeds) as purchase money, and such assets (together with the other net assets of the corporation) are transferred to a new company solely for stock, such assets will be converted to equity capital.

The consequences are not so eminently rational where unrealized appreciation is involved, as may be seen from the following examples:

(1) The aggregate assets of the transferor have a value of $3,500,000 and a basis in the transferor's hands of only $1,000,000; and for simplicity, no liabilities were outstanding. In the reorganization the taxpayer issued for the property its stock having a par value of $1,000,000 and bonds in the face amount of $2,500,000. The invested capital of the taxpayer would be a minus amount, the new company starting out "in the red," so to speak, although its predecessor had an invested capital of $1,000,000 justifying a credit of $80,000! The minus figure is computed as follows:

Basis of property	$1,000,000
Less—bonds issued	2,500,000
Excess of bonds	– 1,500,000
Add borrowed invested capital (50% of $2,500,000)	1,250,000
Total	–$ 250,000

(2) If the added fact that there are $250,000 of accumulated earnings and profits at the beginning of the taxable year is assumed, the invested capital would be exactly zero—despite outstanding debt of $2,500,000; assets employed in the business having a value of $3,750,000; and a tax basis, representing cash invested, of $1,250,000![16]

(3) Assume, further, that accumulated earnings and profits at the beginning of the taxable year have increased to $2,500,000 and that it has thus become possible to retire all the bonds. The invested capital, after the bond retirement would amount to $1,000,000 computed as follows:

Basis of property	$1,000,000
Less—bonds issued	2,500,000
Excess of bonds issued	– 1,500,000
Accumulated earnings and profits	2,500,000
Total invested capital	$1,000,000

[15] Section 751, for some unknown reason, does not make this reallocation if the bonds are received free of tax on the exchange. In such case, they do not qualify as borrowed capital under §751, and do not operate to reduce equity capital.

[16] Under the formula of §§750 and 751, invested capital would more sensibly be $1,250,000.

Note that the minus adjustment with respect to the bonds issued must still be taken into account even though such bonds have been redeemed. The earnings and profits from which the redemption was made remain in invested capital, and thus neutralize the continued minus adjustment, until wiped out by subsequent losses. When the earnings are thus impaired, the continuance of the minus adjustment becomes indefensible. For example, if $1,000,000 in operating losses are then sustained, the invested capital would again be zero, although assets worth $2,500,000 would make up the business.

In transactions where bonds were issued by the taxpayer as a part of the consideration for the property, the invested capital will probably be higher under the computation prescribed by Section 751, because of the special treatment there afforded new bonds. This is especially true in cases where the bonds were called prior to 1940. In such cases it probably would be more advantageous for the taxpayer to avoid electing the provisions of Section 760 in computing invested capital for 1940 and 1941. Of course, for 1942 and subsequent years, there is no option.

As previously noted, it is the function of Section 760 to reduce invested capital by money or other property paid out by the taxpayer in acquiring property on an exchange. This is accomplished by reducing the property paid in on account of "boot," as indicated in the formula. This objective is proper, since such payments may be regarded as in the nature of distributions from capital or accumulated earnings and profits. A minus adjustment, with its distorted consequences, as in the case of new bonds, is incurred where the property received has appreciated, and such appreciation is in effect distributed by means of the exchange. A similar distortion may occur in case of appreciation in value of the assets *paid out* as boot. These assets are reflected in invested capital, either through capital or surplus, in the amount of their tax basis only; and the reduction in invested capital through the operation of Section 760 will be measured by their value. The dubious assumption that the assets coming in will add a tax basis figure equal to such value is indeed a finespun foundation on which to build a practicable statute.[17]

"Identity" Reorganizations

It has already been mentioned that one effect of Section 760 is to reduce invested capital in the amount of any deficit in earnings, if the business passes to a successor company on an "exchange." The Revenue Act of 1942 contains a provision, Section 219, designed to reverse this rule in the limited case where the successor company is in all practical aspects identical with its predecessor.

The objectives of the new provisions[18] is to place the transferee corporation in the same position with respect to invested capital as the predecessor company prior to the reorganization, *i.e.*, to leave equity invested capital unreduced by the occurrence

[17] This weakness may be offset somewhat by the increase in earnings and profits resulting from such disposition of the appreciated boot. This is of little comfort, however, to a corporation which has a deficit at the time of the exchange or thereafter.

[18] INT. REV. CODE §§718(a)(7), (5), (c)(5).

of the deficit, but to require restoration of the deficit out of future earnings before including any plus amount of earnings and profits in invested capital. This is accomplished in part by adding to the invested capital of the transferee, as a separate item, an amount "equal to the portion of the deficit in earnings and profits of a transferor attributable to property received previously to such day,"[19] thus restoring the deficit otherwise reflected through the operation of Section 760 of the Code. The deficit is maintained, for the purpose of computing earnings and profits as an element of invested capital,[20] by treating the transferee as if it had been in existence immediately before the beginning of the taxable year in which the transfer occurred and had then sustained a recognized loss in such amount.[21] The transferor on the other hand, receives the converse treatment. Its equity invested capital is reduced in the amount of the deficit; and its earnings and profits are computed for excess profits tax purposes as if a recognized gain had been realized immediately before the beginning of the taxable year of the exchange.[22]

The situation in which the new provisions may be applied is strictly limited by the following conditions:[23]

(1) "Substantially all" the property of the transferor corporation must be transferred to the transferee corporation.[24]

(2) The latter corporation must have been "formed to acquire such property."

(3) The "sole consideration" for the transfer of the property must be the transfer of all the stock (except qualifying shares) of the transferee to the transferor or its shareholder. However, the assumption of the transferor's liabilities, and liabilities to which the property is subject, are disregarded.[25]

[19] *Id.* §718(a)(7). Obviously, it will be impossible to attribute a deficit to particular property. This provision must mean that if less than all the assets are transferred, the deficit will be pro-rated in accordance with the proportion of the property transferred. It is so construed in U. S. Treas. Reg. 109, §718-7, as amended by T.D. 5267, May 27, 1943.

[20] This will require a double computation of earnings and profits for tax purposes, as well as book surplus for corporate purposes.

[21] INT. REV. CODE §718(c)(5). This rule would seem to follow as a matter of course under the general theory of Commissioner v. Sansome, 60 F. (2d) 931 (C.C.A. 2d, 1931). It is possible, however, that the "Sansome rule" may not apply to deficits. See Rudick, *"Dividends" under the Income Tax Law* (1941) 89 U. OF PA. L. REV. 865, 896. In any event, the statutory rule should be read as at most ratifying and not duplicating the "Sansome" adjustment.

[22] These adjustments will be of little consequence. The new provisions apply only to the determination of daily invested capital after the exchange. Since the transferor must be "forthwith completely liquidated" (condition (5) in the subsequent text), adjustments to the transferor's invested capital will be for a brief period only.

[23] INT. REV. CODE §718(c)(5).

[24] *Cf. id.* §112(g)(1)(C). The phrase "substantially all," has not proved a very satisfactory legislative tool in the past. See Pillar Rock Packing Co. v. Comm'r, 90 F. (2d) 949 (C.C.A. 9th, 1937) (68% insufficient); Comm'r v. First National Bank of Altoona, 104 F. (2d) 865 (C.C.A. 3rd, 1939) (86% sufficient); Western Industries Co. v. Helvering, 82 F. (2d) 461 (App. D.C., 1936); Gross v. Comm'r, 88 F. (2d) 567 (C.C.A. 5th, 1937); Daily Telegram Co., 34 B.T.A. 101 (1936); American Foundation Co. v. U. S., 120 F. (2d) 807 (C.C.A. 9th, 1941) (value, not cost, is the measure); Schuh Trading Co. v. Comm'r, 95 F. (2d) 404 (C.C.A. 7th, 1938) (worthless assets disregarded); Milton Smith, 34 B.T.A. 702 (1936) (assets withheld to pay debts disregarded).

[25] *Cf.* INT. REV. CODE §§112(b)(5), (g)(1)(C); U. S. v. Hendler, 303 U. S. 564 (1938); Helvering v. Southwest Consolidated Corp., 315 U. S. 194 (1942).

(4) The transferor's basis for the property must carry over to the transferee.[26]

(5) The transferor must be "forthwith completely liquidated" in pursuance of a plan under which the property is acquired; and

(6) "Immediately after the liquidation"[27] the shareholders of the transferor must own all such stock.

The foregoing treatment of "identity" reorganizations does not approach an adequate treatment of the problem. For example, the new provisions completely fail, apparently, to cover the case of two or more transferors of assets to the new corporation, or the merger of existing corporations, even though proportionate interests are rigidly maintained.[28] They cover only by implication the statutory merger of a predecessor and a new successor company—i.e., only if they recognize the constructive transfer of assets for stock, followed by a liquidating distribution and dissolution, in such a transaction. Moreover, the stringent limitations of the provisions will inevitably make their application very difficult. For example, the consideration must be limited "solely" to stock and assumed liabilities (or liabilities to which the property is subject), and this will exclude many reorganizations involving substantial identity merely because of new debt securities, stock warrants, liabilities assumed in the course of reorganization, and various other elements in the transaction which may in some way be classed as "consideration" other than stock and assumed liabilities. It will also unquestionably be necessary to cope with the question as to whether new debt securities issued in lieu of those outstanding at the time of reorganization represent an "assumption" of liabilities.[29]

Intercorporate Liquidations

Section 761 of Supplement C provides rules for the adjustment of invested capital at the time of tax-free intercorporate liquidations. It replaces Section 718(a)(5) and (b)(4), which do not apply to taxable years beginning after December 31, 1941. Here, also, the taxpayer may elect to apply Section 761 to all years beginning after December 31, 1939 in lieu of Section 718(a)(5) and (b)(4).

The latter sections contemplate application only to tax-free liquidations under Section 112(b)(6) occurring since January 1, 1936. They provide an increase or

[26] INT. REV. CODE §§112(g)(1)(C), 113(a)(7)(B). This would seem to follow as a matter of course without such a provision. The function or purpose of the phrase "for the purposes of this subsection" in the new §718(c)(5)(B) is not readily apparent.

[27] The phrase "immediately after" the transfer or exchange has also proved a serious legislative stumbling block in the past. See INT. REV. CODE §§112(b)(5), (g)(1)(D), 113(a)(7)(A); Bassick v. Comm'r, 85 F. (2d) 8 (C.C.A. 2d, 1936), *cert. den.* 299 U. S. 592 (1936); Hazeltine Corp. v. Comm'r, 89 F. (2d) 513 (C.C.A. 3d, 1937); Comm'r v. Schumacker Wall Board Corp., 93 F. (2d) 79 (C.C.A. 9th, 1937); Case v. Comm'r, 103 F. (2d) 283 (C.C.A. 9th, 1939); Heberlein Patent Corp. v. U. S, 105 F. (2d) 965 (C.C.A. 2d, 1939); Portland Oil Co. v. Comm'r, 109 F. (2d) 479 (C.C.A. 1st, 1940), *cert. den.* 310 U. S. 650 (1940); Briggs-Darby Construction Co. v. Comm'r, 119 F. (2d) 89 (C.C.A. 5th, 1941); Handbird Holding Corporation, 32 B.T.A. 238 (1935); Columbia Oil & Gas Co., 41 B.T.A. 38 (1940), *aff'd*, 118 F. (2d) 459 (C.C.A. 5th, 1941); Wilgard Realty Co., 43 B.T.A. 557 (1941).

[28] See U. S. Treas. Reg. 109, §30.718-7.

[29] *Cf.* Helvering v. Taylor, 128 F. (2d) 885 (C.C.A. 2d, 1942); Louis E. Stoddard, 47 B.T.A. 584 (1942).

decrease of invested capital in the amount of the "gain" or "loss" on the liquidation. The "gain" or "loss" is based on the formula prescribed by the two sections. A gain is the excess of the adjusted basis of property received in the liquidation over the sum of the adjusted basis of the stock, the aggregate of liabilities assumed by the parent (or to which the property was subject) and the amount of any consideration given by the parent in connection with the liquidation. Conversely, a loss is the amount by which the basis of stock, liabilities assumed and any other consideration given, exceeds the basis of property received. Such losses are to be taken into account only to the extent of the parent's earnings and profits at the beginning of the taxable year for which invested capital is computed.

Section 761 is more complicated. Under this provision an "intercorporate liquidation" contemplates not only the receipt by the taxpayer of property on a complete liquidation which is tax-free under Section 112(b)(6) of the Code, or a corresponding provision of prior law (as in the case of Section 718(a)(5) and (b)(4)) but also the receipt of property on an intercorporate liquidation to which "a provision of law is applicable prescribing the non-recognition of gain or loss in whole or in part upon such receipt (including a provision of the regulations applicable to a consolidated income or excess profits tax return, but not including Section 112(b)(7), (9) or (10) or a corresponding provision of a prior revenue law)."[30] The writers have found no significance in the quoted subsection beyond the intercorporate liquidation during a consolidated return period,[31] since it is immediately followed by a limiting phrase—"but only if none of such property so received is a stock or a security in a corporation the stock or securities of which are specified in the law applicable to the receipt of such property as stock or securities permitted to be received (or which would be permitted to be received if they were the sole consideration) without the recognition of gain." The latter clause eliminates the application of the section to the constructive liquidation involved in a "reorganization" of the subsidiary under which the taxpayer, as the parent, exchanges its stock in the old subsidiary for stock in the successor or reorganized corporation—no real change having occurred in the parent's position.

The operative provisions of the section are a prime example of the complex technique in legislative draftsmanship of which we have seen so much in recent times. Two working concepts—the "plus adjustment" and the "minus adjustment" —are set up in Section 761(b)(1) and (2) with a third provision, Section 761(b)(3), supplying the "rules" for arriving at such concepts under their individual definitions. In brief, the "plus adjustment" is the excess of money and the adjusted basis of

[30] INT. REV. CODE §761(a). Note that the section erroneously refers to a non-existent §112(b)(10) of the Code, which was never enacted either as a Code provision or as a counterpart under prior laws; and to §112(b)(7) of the Code, which has never existed as a Code provision, although it was part of the Rev. Act of 1938. However, §112(b)(9) is an accurate reference to a new provision on railroad reorganizations.

[31] Statutory mergers and consolidations, where the surviving corporation owned stock in the merged company, are separately covered in §761(f), under which the property attributable to such stock is treated as having been liquidated on an intercorporate liquidation.

property, net of liabilities assumed, liabilities to which the transferred property is subject, and "boot" received by the taxpayer on the intercorporate liquidation over the adjusted basis of the shares surrendered therefor. The converse is the "minus adjustment." These formulas correspond to the "gain" and "loss" on tax-free liquidations under Section 718(a)(5) and (b)(4).

With the concepts of a "plus adjustment" and a "minus adjustment" thus tentatively defined, Section 761(c) lays down additional "rules" which represent merely a further development of the meaning of such concepts for purposes of the section. These "rules" fall into two parts: (a) the rule where the liquidated stock has a "cost basis";[32] and (b) the rule where the liquidated stock has "other than a cost basis."[33]

The rule as to stock having a cost basis in effect specifies an artificial basis to be attributed to the property transferred in liquidation of the shares held by the taxpayer, for purpose of computing the plus or minus adjustment. The substance of it is to give to the net assets, for such purpose, the basis (adjusted cost) of the surrendered stock. Where the stock has "other than a cost basis," the normal carry-over basis of the assets is used in computing the plus or minus adjustment.[34]

After these definitions are thus finally completed, Section 761(d) and (e) prescribe the operative rule of the new provision. The plus adjustment or minus adjustment is to be made to the earnings and profits account of the taxpayer in the case of stock having a cost basis; and to the equity invested capital, as an additional element thereof under Section 718(a) or a reduction thereto under Section 718(b), in the case of stock having a basis other than a cost basis. Further, the assets are thereafter to retain the basis used in computing the plus or minus adjustment for all invested capital purposes.[35]

The Commissioner, with the approval of the Secretary, is specifically authorized to issue regulations as to the various determinations under the new provision, and with respect to liquidations extending over a long period of time.[36]

As previously indicated, the adjustment provided by Section 761 makes a distinction between liquidations where the stock of the subsidiary was held on a cost basis and those where the basis was other than a cost basis. The adjustment is to be made with reference to each share held, so that one rule may apply to part of the stock, and the other rule may apply to the rest. In the case of stock held with a basis other than cost, the adjustment is substantially that prescribed by Section

[32] INT. REV. CODE §761(c)(1). [33] *Id.* §761(c)(2).

[34] *Ibid.* Query whether stock the basis of which is determined by reference to the basis of stock previously held (which had a cost basis) is stock having "other than a cost basis." It should not be so treated, but §113(a) of the Code treats basis so determined as an exception to the rule that the basis of property is cost. See §113(a), (a)(6). Note that the consolidated returns regulations more carefully refer to basis carried over from a predecessor. U. S. Treas. Reg. 110, §§33.31(c)(2)(iv)(F), (G), and (v)(A), as amended by T.D. 5245, March 13, 1943.

[35] This will require a separate computation of earnings and profits for excess profits tax purposes. Note that the assets retain such basis even though transferred to another corporation, if a carry-over basis normally results from the transfer. See §761(e).

[36] INT. REV. CODE §761(g).

718(a)(5) and (b)(4)—the difference being that the adjustment under Section 718(b)(4) is limited to the amount of the taxpayer's earnings and profits, whereas this is not true under Section 761. It is not clear from the legislative history of Section 761 that this difference represents an intentional and not an inadvertent change of policy.

The theory behind the adjustment in the case of stock having a substituted basis will readily be seen if it is assumed that stock of the subsidiary was acquired in exchange for all of the stock of the taxpayer upon the organization of the latter and the subsidiary was subsequently liquidated in a tax-free liquidation. The invested capital of the taxpayer would consist of the basis of the subsidiary's stock originally paid in, increased or decreased by the difference between such basis and the net basis of the subsidiary's properties received in liquidation. Thus, the invested capital of the taxpayer would equal the aggregate tax basis of the subsidiary's assets reduced by its liabilities (which were assumed by the taxpayer). If the subsidiary had a balance of accumulated earnings at the time of liquidation, in theory the taxpayer would have invested capital exactly equivalent to the invested capital of the subsidiary. In view of the subsidiary's stockholders' continuity of interest in the taxpayer, this result is proper.

Suppose, however, that the subsidiary had an operating deficit at the time of liquidation. As in the case of Section 760, the invested capital surviving the Section 761 adjustment will be reduced in the amount of the deficit, since it turns on the basis of assets still held and therefore will reflect an elimination or reduction of assets through operating losses. While the provisions relating to deficits at the time of "identity reorganizations" seek, in a limited way, to counteract this effect under Section 760, no counterpart exists with respect to the same problem under Section 761.

In cases where the basis for the liquidated subsidiary's stock was a cost basis, Section 761 takes an entirely new approach. The effect of the adjustment is to treat the assets of the subsidiary attributable to such stock as if they had been purchased directly by the taxpayer at the time the taxpayer acquired control of the subsidiary. Moreover, whatever adjustment is necessary to achieve this result is made directly to earnings and profits as if realized by a sale. "Control" for this purpose is defined in Section 761(c)(3) as 80% of the voting stock, if such ownership continues until the liquidation has been completed. The method of computing the adjustment is elaborate and may best be shown by an example:

Assume that corporation *A*, the taxpayer, purchased all the stock of corporation *B* for $1,400,000. At the date of purchase *B* had depreciable property with a tax basis of $800,000 and no other property or liabilities. Thus, if the property is considered to have as its basis *A's* cost for the stock, the property will have a basis of $1,400,000. Next assume that at the time *B* was liquidated, the property was 50% depreciated and that *B* had other assets of $600,000 and no liabilities. The adjustment to be made on account of the liquidation of *B* would be computed as follows:

Depreciable property (basis under §761(c) at acquisition of control)	$1,400,000
Depreciated 50%	700,000
Leaving adjusted basis	700,000
Other assets	600,000
Total assets received in liquidation	1,300,000
Basis for *B's* stock	1,400,000
Minus adjustment to earnings and profits of *A*	$ 100,000

This result is quite different from that reached under the adjustment prescribed by Section 718(a)(5) and (b)(4), which would be as follows:

Depreciable property (*B's* income tax basis)	$ 800,000
Depreciation 50%	400,000
Leaving adjusted basis	400,000
Other property	600,000
Total assets received in liquidation	1,000,000
Basis for *B's* stock	1,400,000
Reduction of invested capital under §718(b)(4)	$ 400,000

The adjustment prescribed in this case under Section 761 is to be made to earnings and profits of the taxpayer, as if the taxpayer had realized a gain or loss equal to the plus or minus adjustment. In addition, the earnings and profits of the taxpayer, for the period following the liquidation, are to be computed by using this special basis for the assets received from the subsidiary—defined as "invested capital basis" by Section 761(e). In the example given, *A* would use the basis of $700,000 for computing depreciation on the property acquired from *B*. This basis would be used to compute depreciation or gain or loss from sale to be taken into account in computing earnings and profits for invested capital purposes. In computing its taxable net income *A* would use the adjusted income tax basis of $400,000, which is a substituted basis carried over from the liquidated subsidiary. For example, if during the period from the date of liquidation to the beginning of the taxable year the property received from *B* depreciated 10%, a charge of $40,000 would be reflected in *A's* income for income tax purposes. The adjustment required by Section 761, in addition to that for loss on liquidation, would be a further charge against accumulated earnings and profits of $30,000 representing a difference between 10% of $700,000 and 10% of $400,000. As already mentioned, this reduction of earnings and profits by an adjustment of the charge for depreciation from $40,000 to $70,000 would be made only for the purpose of computing the earnings and profits to be included in invested capital. The invested capital basis for such assets would also be used, however, for the purpose of the inadmissible asset ratio computation.

In the example the old rule and the new rule will tend to produce the same result by the time the property is fully depreciated, or in the event of sale. The difference would be more pronounced, however, if the excess of the cost of the stock over the tax basis of the subsidiary's assets represented a non-depreciable asset unlikely to be sold, such as good will. Under the old sections, the amount paid for such stock representing good will for which the subsidiary had no tax basis, becomes a reduction of the parent's invested capital at the time of the liquidation. Under the Section 761 adjustment, the amount of such good will would be taken into account as an asset at the amount paid for it by the parent through purchase of the subsidiary's stock. Thus, in such cases the taxpayer might increase the invested capital for 1940 and 1941 by making the election to apply Section 761 rather than Section 718(a)(5) and (b)(4).

Section 761 is replete with technical defects, and will either have to be rewritten, or perfected through a bold use of the power to make regulations. By way of supporting this general criticism, a few examples will be given, as follows:

(1) The simple situation in which a parent company purchases all of a subsidiary's stock for cash, and later contributes more capital to the subsidiary in exchange for additional stock, gives rise to a puzzling problem as to the manner of determining the assets attributable to shares of stock for purposes of an adjustment under Section 761 at the time of intercorporate liquidation. The proper result appears to be obtainable only by treating the amount paid in for the additional stock as a contribution to capital, increasing *pro rata* the basis of the shares previously held, rather than by attempting asset basis allocations on account of the stock subsequently acquired on the theory that such stock was independently purchased for cash.

(2) Section 761 refers merely to property received on liquidation attributable to a share of stock. No provision is made for the ordinary situation in which several classes of stock are held by the parent company and all are liquidated simultaneously. Some method of attributing the basis, in the case of shares purchased, of particular stock to the assets attributable to that stock, must be devised.

(3) Assume corporation *A* purchased for $1,000,000 in cash 80% of the stock of corporation *B*. Subsequently, corporation *A* issued 1,000 shares of its voting stock to corporation *B* in exchange for *B's* property. After this transaction *B* was liquidated, and corporation *A* received back (and cancelled) 800 shares of its own stock in the liquidation.[37] The application of Supplement C would seem to permit *A* to include as property paid in for stock, all of the assets of *B* thus acquired. The transaction by which *A* received its own stock in liquidation of *B* would seem not to be included in the definition of intercorporate liquidation under Section 761. Accordingly, *A* would seem to have a duplication in invested capital to the extent of

[37] This type of transaction is exemplified by Helvering v. Winston Bros. Co., 76 F. (2d) 381 (C.C.A. 8th, 1935), and General Motors Corporation, 35 B.T.A. 523 (1937).

the $1,000,000 cash used to purchase stock of *B* since this $1,000,000 would represent either capital paid in to or accumulated earnings of *A*—unless the surrender by *A* of stock in *B* for cancellation upon the liquidation of *B* could be properly regarded as a distribution of a $1,000,000 asset in retirement of its own shares.

(4) Assume that corporation *X* purchased all the stock of *Y* corporation for $2,000,000 and that the assets of *Y* had an aggregate basis of $500,000. *X* transferred the stock of *Y* to the taxpayer in exchange for all of the taxpayer's stock and $1,000,000 of bonds. Subsequently, the taxpayer acquired the assets of *Y* by a tax-free liquidation. The invested capital of *Y* would be zero, computed as follows:

Basis of *Y's* stock paid in (cost to *X*)	$2,000,000
Less—bonds issued	1,000,000
Property paid in, §760	$1,000,000
Less—minus amount from tax-free liquidation representing difference between $2,000,000, the basis for *Y's* stock, and $500,000, the basis for *Y's* assets received	1,500,000
Net equity invested capital	−500,000
Borrowed capital (50% of $1,000,000)	500,000
Total	000,000

This result is obviously unsound since the taxpayer began operations with property having a tax basis of $500,000 and with borrowed capital outstanding of $1,000,000. Presumably the proper result would be obtained in a case such as this if the basis of the stock to be used in computing the plus or minus adjustment resulting from the liquidation, were the same basis determined under Section 760 as the amount includible in invested capital for the purposes of Section 718(a). Of course, if it were provided that the basis for *Y's* stock to the taxpayer is a cost basis, then the minus adjustment would not apply and the correct result would be produced.

(5) In some cases a parent corporation has purchased a substantial portion of the stock of the subsidiary but has not acquired until much later the 80% control referred to in Section 761. The adjustments prescribed in Section 761 adopt the date upon which 80% control is acquired as the time when the basis of the subsidiary's assets are to be adjusted with reference to the cost of its stock to the parent. Thus, for example, assume that 75% of the subsidiary's stock were purchased for an amount exactly equal to 75% of the aggregate tax basis of its assets and the subsidiary thereafter accumulated substantial earnings prior to the date on which additional stock was acquired, giving the parent 80% control. The assets of the subsidiary attributable to the 75% of the stock, would exceed the cost by 75% of the accumulated earnings. The adjustment prescribed would require that the subsidiary's assets attributable to 75% of the stock be scaled down to exclude the accumulated earnings attributable to such stock. There does not seem to be any reason behind this adjustment except

that, to avoid being forced into an even more complicated set of rules which would produce the proper result in each individual case, the arbitrary date on which 80% control was acquired was probably selected.

(6) Section 761(e) prescribes the so-called "invested capital basis" under which property received by the transferee in an intercorporate liquidation is thereafter for invested capital purposes regarded as having the same basis which was attributed to it under the plus and minus adjustment formula. Thus, in the case of the stock of a subsidiary having been acquired for cash, this provision requires that the cash purchase price of the stock ultimately become the tax basis of the subsidiary's assets. The application of this new basis to the assets is limited, however, to the case of property received "in an intercorporate liquidation." It commonly happens that assets are transferred from a subsidiary to a parent as a distribution from capital, with the intention that the subsidiary shall retain the remainder of the assets and continue operations. This distribution frequently would not qualify as an "intercorporate liquidation" even though the subsidiary was wholly owned. At a later point the subsidiary might be liquidated, and the assets then distributed would take the new basis for invested capital purposes, while those previously distributed would take a basis determined in light of the income tax law applicable to the prior distribution. This inconsistent and conglomerate result can be explained only as an oversight on the part of the draftsmen.

II. THE INCOME CREDIT

The Income Credit in General

The income credit, popularly known as the "average earnings credit," rests upon the simple proposition that the normal portion of a corporation's current earnings can be determined by reference to its average earnings during a representative pre-war period. The pre-war period 1936 to 1939 inclusive has been selected as a period of moderate prosperity for business in general.[38]

The embodiment of this basic proposition in the statute can be illustrated by applying the income credit to a corporate taxpayer which had reached its full normal growth by the beginning of the base period, which continued its customary business through the base period uninterrupted by any unusual or peculiar events, without any changes in its corporate set-up and as a member of an industry with a past record of consistent earnings and a normal business cycle.

For such a corporation reporting on a calendar year basis, the statute simply provides an excess profits credit of 95% of its average base period net income for the calendar years 1936 to 1939 inclusive, plus 8% of its net capital addition and less 6% of its net capital reduction.[39] The average base period net income for such a cor-

[38] See *The Revenue Bill of 1942:* H. R. REP. No. 2333, 77th Cong., 2d Sess. (1942) 143; SEN. REP. No. 1631, 77th Cong., 2nd Sess. (1942) 199. (Hereinafter cited as "HOUSE REPORT" and "SENATE REPORT," respectively.)

[39] INT. REV. CODE §713(a).

poration is determined by making certain adjustments in its normal tax net income[40] for each of the base period years comparable to the adjustments prescribed for converting the current normal tax net income into excess profits net income.[41] Capital additions consist of increases in cash or property paid in for stock or as a contribution to capital, or as paid-in surplus, since the end of the base period, less increases in assets the income from which is not subject to the excess profits tax[42] ("excluded capital"). Capital reductions consist of distributions out of capital to stockholders since the end of the base period.[43] The net capital addition consists of the excess of additions over reductions. The net capital reduction consists of the excess of reductions over additions.

Aside from the minor adjustment from 100% to 95% of the average base period net income and, perhaps, the failure to recognize as a capital addition either accumulations of earnings since the end of the base period or 50% of borrowed capital acquired since the end of the base period, the statute produces a reasonably fair and simple measure of normal earnings for the corporate enterprise. Simplicity is converted into complexity, however, when an attempt is made to provide in the statute for the innumerable factors which tend to prevent the base period experience from being a fair measure of normal profits.

For example, the corporation may have been growing in the base period, without reaching its maturity until after the base period had ended. The larger profits in the current taxable year as compared to the average base period profits may represent merely mature profits rather than excess profits. The corporation may even have commenced business after the base period began and, therefore, is without any earnings at all for part of the period. Strikes, floods, fires, price wars or one or more of a host of other unusual or peculiar events may have occurred to interrupt or retard base period activity. Changes may have occurred in the character of the corporation's business the full effect of which may not have been reflected in the base period earnings. The base period may not constitute a representative period for the industry of which the corporation is a member. Finally, the present corporate enterprise may not even be the same enterprise that was operating throughout the base period by reason of mergers, consolidations, split-ups, liquidations and other rearrangements of corporate activity.

Any of the foregoing factors is capable of preventing the average base period earnings from being a proper standard of normal earnings in a particular case. Consequently, it has been found necessary to provide a number of variations in, and additions to, the basic statutory rule underlying the income credit in order to prevent discrimination and at the same time prevent windfalls. Most of the foregoing situations are taken care of, or are capable of being taken care of, by the application of Section 713(d)(2),[44] which fills up vacant periods during the base period with

[40] *Id.* §711(b).

[41] *Id.* §711(a).

[42] *Id.* §713(g)(3).

[43] *Id.* §713(g)(4).

[44] And its counterpart in Supplement A, §742(e).

constructed earnings determined by reference to the corporation's invested capital at the beginning of the base period; by Section 713(e)(1),[45] the so-called automatic relief provision which permits the taxpayer to bring its leanest base period year up to 75% of the average for the other three base period years; by Section 713(f)[46] which prescribes the so-called normal growth formula in lieu of the four-year average rule;[47] by Section 722, the well-known general relief provision; and by Section 713(g)(5) and Supplement A which deal primarily with corporate rearrangements.

Thus, a simple rule of thumb has been developed largely by necessity into a maze of complicated phraseology with each clause and sentence presenting material for careful study. The discussion herein will be limited to a consideration of the provisions which deal primarily with corporate rearrangements, namely, Section 713(g)(5) and Supplement A.

Section 713(g)(5): Corporate Split-ups and Other Stock Relationships

Section 713(g)(5) was introduced into the excess profits tax law by Section 216 of the Revenue Act of 1942.[48] It was immediately recognized as the Treasury's solution for a loophole in the statute which had remained open from the time it first appeared in the 1940 Act. Prior to the introduction of this provision, a corporation, on the income credit basis and without any net capital addition could, in 1940 or 1941, transfer a portion of its assets to a subsidiary and thereby create or increase an invested capital credit for the subsidiary without affecting its own income credit. True, if an existing subsidiary was used for such purposes, the step was taken with the expectation that the subsidiary would be forced to abandon its own highest bracket amount and share that belonging to the parent.[49] This disadvantage, however, served only as a minor deterrent where sizable transfers were involved and now such disadvantage has been removed by the retroactive repeal of the highest bracket amount provisions.[50]

Generally speaking, the aim of the new provision is to establish a capital reduction (not merely an offset to the capital addition, if any)[51] of a corporation, based on increased holdings of affiliates within the same "controlled group." However, the structure of the section is such as to raise considerable doubt as to how far and how well this aim will be achieved. The principal operative provisions of Section 713(g)(5) are as follows:

[45] And its counterpart in Supplement A, §742(b)(2).

[46] And its counterpart in Supplement A, §742(h).

[47] §713(e).

[48] The amendment is not retroactive. It applies only to taxable years beginning after December 31, 1941.

[49] §752 of the INT. REV. CODE prior to 1942 Act.

[50] Rev. Act of 1942, §229(a)(1).

[51] To avoid a duplicate adjustment, it is provided that excluded capital shall be reduced by any increase in capital reduction as a result of the operation of the section.

(5) If, on any day of the taxable year, the taxpayer and any one or more other corporations are members of the same controlled group, then the daily capital reduction of the taxpayer for such day shall be increased by whichever of the following amounts is the lesser:

(A) The aggregate of the adjusted basis (for determining loss upon sale or exchange) of stock in such other corporation (or if more than one, in such other corporations) acquired by the taxpayer after the beginning of the taxpayer's first taxable year under this subchapter, minus the aggregate of the adjusted basis (for determining loss upon sale or exchange) of stock in such other corporation (or if more than one, in such other corporations) disposed of by the taxpayer prior to such day and after the beginning of the taxpayer's first taxable year under this subchapter; or

(B) The excess of the aggregate of the adjusted basis (for determining loss upon sale or exchange) of stock in all domestic corporations and of obligations described in Section 22(b)(4), held by the taxpayer at the beginning of such day over the aggregate of the adjusted basis (for determining loss upon sale or exchange) of stock in all domestic corporations and of obligations described in Section 22(b)(4), held by the taxpayer at the beginning of its first taxable year under this subchapter.

The definition of "controlled group" is virtually the same as that contained in the existing provisions with respect to "new capital."[52] A connecting link of more than 50% of total combined voting power, or of total value, is enough to bring a corporation within the chain of corporations constituting the controlled group.

When an attempt is made to ascertain the net effect of the new provision, it will be noted first that it is written in terms of affiliates' stock *acquired or disposed of since the base period*. It overlooks the ability of a parent to transfer assets, as a contribution to capital or paid-in surplus, to a subsidiary in existence before the end of the base period without acquiring any additional stock.

In addition, the objective of the section may in some cases be frustrated for other reasons. The net balance of acquisitions and dispositions under clause (A) is measured in terms of the *basis* of the stock owned by the taxpayer; and shares held prior to the excess profits tax are included in the computation.[53] Moreover, the reduction by reason of an increase in stockholdings within the "controlled group" is limited by the amount of the net increase, under clause (B), in excluded capital in general (stocks of all domestic corporations and tax-exempt securities). The result is that by disposing of high basis shares previously held (for example, a portfolio of depreciated and undesirable securities in affiliated companies held merely as investments) and transferring to a new subsidiary low basis assets in order to keep the basis on the acquired shares at a minimum, it might still be possible to eliminate or minimize the capital reduction while creating additional credit for the subsidiary. Or a corporation having a group of high basis "cats and dogs" qualifying as excluded capital and held prior to the imposition of the excess profits tax might clean

[52] INT. REV. CODE §718(a)(6).

[53] Shares disposed of prior to the day in question are included in the computations of shares held at the beginning of the first excess profits tax year at their basis under the law in effect at the time of disposition.

them out, replace them with a new subsidiary's stock having an equal basis, and because of clause (B) again escape the capital reduction. Moreover, the additional specific exemption, and the excess of the credit based on the subsidiary's invested capital over the loss of credit by the parent,[54] will also prevent full elimination of the tax advantage.

On the other hand, the provision will in some instances apply where the tax-avoiding split-up is not present. Suppose corporation *A* owns indirectly (through several intermediate corporations similarly connected) non-voting preferred stock of corporation *B* exceeding in value 50% of the total value of *B's* several classes of stock. *B* has no capital addition. The management of *B*, which is by no means controlled by *A*, purchases some preferred stock of *A* in the open market as an investment. Without more, *B* suffers a reduction in its income credit. Yet even if *B* had bought its *own* shares as an investment, apparently no capital reduction would have been suffered;[55] and, of course, none would have occurred if the purchased stock had been that of a non-affiliate.

Supplement A: Merged and Reorganized Companies

Supplement A of the excess profits tax, contained in Sections 740 to 744 of the Code, occupies the same position with respect to the income credit as Supplement C does with respect to invested capital. As Supplement C provides the method of aggregating the invested capital credits of consolidated enterprises, and passing invested capital from one company to another, so Supplement A seeks to coalesce the base period income experience of corporations absorbed into a single enterprise.

In actual operation it has no less a yield of knotty problems, requiring comparable finespun treatment. These problems grow out of many complicating factors such as the standards for eligibility; necessary adjustments for capital changes; "vacant" years, short years, or differing fiscal years in the base period; and the risk of duplication where the transferee of the assets (termed the "acquiring" corporation) and the transferor (termed the "component" corporation) both survive the transaction, or where there has been cross-ownership of stock between them.

Supplement A was extensively revised by the 1942 Act. With certain exceptions, hereinafter noted, the revisions may be applied retroactively to all excess profits tax years at the election of the taxpayer.[56] Such an election is normally advantageous when Supplement A is used. Accordingly, the discussion will refer to Supplement A as amended.

Eligibility for Supplement A: Types of Transactions Included

By virtue of the 1942 Act, the right to use Supplement A has been extended to all corporations in existence before January 1, 1940, or having a component in ex-

[54] Due to a rate of return on invested capital (maximum 8%) higher than the rate of adjustment for capital reduction (6%).

[55] *Cf.* U. S. Treas. Reg. 109, §30.718-5.

[56] Rev. Act of 1942, §228(f); U. S. Treas. Reg. 103, §30.742-2(e).

istence before such date. Under prior law, a corporation only constructively in existence prior to January 1, 1940 (by reason of having a component actually in existence prior to such date) was compelled to use Supplement A, and one actually in existence prior to such date was put to an election between Supplement A and Section 713.[57] Now the taxpayer, in computing its average base period net income, is in effect entitled to the greatest of the regular or general average method; the growth provision; the Supplement A method; or the Supplement A—growth method. Moreover, only one set of computations need be submitted on the return, without disclaimer (as under prior law)[58] of other methods, and the return is to be audited on the method so used. The taxpayer is not precluded, however, from shifting his method so long as the year remains open for adjustment.[59]

The 1942 Act made no change in the types of transactions covered by Supplement A. Section 740(a), which defines the term "acquiring corporation," limits the types of such transactions as follows:

(1) The acquisition by one corporation of substantially all the properties of another corporation where part or all of the consideration therefor is the transfer to such other corporation of all the stock of the acquiring corporation other than qualifying shares—Section 740 (a)(1)(A).

(2) The acquisition by one corporation of substantially all the properties of another corporation where the sole consideration therefor is voting stock of the acquiring corporation—Section 740(a)(1)(B).

(3) The acquisition by one corporation, prior to October 1, 1940, of properties of another corporation solely as paid-in surplus or as a contribution to capital, in respect of voting stock of the acquiring corporation owned by such other corporation —Section 740(a)(1)(C).

(4) The acquisition by a corporation of substantially all the properties of a partnership or sole proprietorship in an exchange which is or was covered by Section 112(b)(5), or so much of Section 112(c) or (e) as refers to Section 112(b)(5), or by a corresponding provision of prior law—Section 740(a)(1)(D) and (h).

(5) A tax-free liquidation under Section 112(b)(6) of the Code or a corresponding provision of prior law—Section 740(a)(2).

(6) A statutory merger or consolidation—Section 740(a)(3), (4).

With respect to (2) and (3) above, it is necessary that the corporation transferring its properties shall be completely liquidated forthwith in pursuance of the plan under which the transfer is made, and the transaction must have "the effect of a statutory merger or consolidation"—Section 740(a)(1). In determining whether the property was acquired in such exchanges solely for voting stock, as paid-in surplus, or as a contribution to capital, the assumption of liabilities is disregarded.

[57] Compare the first paragraph of old §742 with the section as revised by §228(c) of the Rev. Act of 1942.

[58] Old §741(b) is repealed. See Rev. Act of 1942, §224(b).

[59] See Rev. Act of 1942: HOUSE REPORT, 153-154; SENATE REPORT, 218.

All the above transactions are, as a matter of form, of the kind with respect to which, under the law in effect since the beginning of the base period, gain or loss is not recognized and where the basis of the property in the hands of the transferor carries over to the transferee.[60] In some cases this result follows from the fact that the transaction fits the definition of the term "reorganization" in Section 112(g)(1). The question naturally arises in such cases, therefore, as to whether eligibility for Supplement A treatment depends on meeting the additional tests that have been superimposed on the statute by judicial doctrine in the "reorganization" field. These include principally the "business purpose" and "continuity of interest" requirements and the "party to a reorganization" doctrine, which have been mentioned above in the discussion of the invested capital provisions.[61]

Although the matter is not entirely clear, it seems probable that such reorganization tests will be read into Supplement A by the courts. The regulations flatly so state,[62] and they would appear to be supported by enough of the rather inconclusive evidence of Congressional purpose to withstand attack.[63]

If it is true, however, that Congress intended to require Supplement A transactions to fit the mold of a tax-free reorganization, there nevertheless remains the question whether such a requirement reflects sound policy in light of the basic purpose which Supplement A should serve. The fundamental purpose of Supplement A would patently appear to be to permit the use of base period experience in cases where the assets contributing to such base period income find a new owner. There would appear to be no reason why this principle should not be extended to all cases where such assets are transferred to new ownership, provided (1) the danger of duplication in the use of base period experience is eliminated, and (2) the assets are dealt with as going business units, so as to avoid the difficulty of deciding how to allocate the base period earnings experience.

Possibly this latter qualification justifies for the most part the present limitations

[60] As to contributions to capital, type (3) above, see §113(a)(8)(B). Types (4) and (5) are expressly related to the tax-free provisions of §§112(b)(5) and 112(b)(6). See, as to basis, §§113(a)(8)(A) and 113(a)(15). Types (1), (2) and (6) above are not expressly tied in with the tax-free provisions of §112, but, as a matter of form, they qualify under the definition of a "reorganization" in §112(g)(1). See §112(g)(1), subsections (D), (C), and (A) respectively. See, as to basis, §§113(a)(6) and (7).

[61] See note 8, *supra*.

[62] U. S. Treas. Reg. 109, §30.740-2(b).

[63] The statute itself offers only slight evidence tending both ways. In opposition to the regulations it might be noted that the general heading of the supplements to the excess profits tax law is "Rules in Connection with Certain Exchanges"; and the word "reorganization" is not used in Supplement A. Moreover, from the fact that a tax-free result is expressly required in connection with liquidation transactions mentioned in §740(a)(2), it might be argued, on the *expressio unius* theory, that a tax-free result is not necessary with respect to §§740(a)(1)(A) and (B) (types (1) and (2) above). On the other hand, several cross references in §§711, 712 and 713 mention Supplement A as providing the rule in the case of "certain reorganizations." §711(b)(1), §712(a) and (d), §713(d)(4). And in addition, there are some general references in the committee reports to the transactions here in question as "tax-free exchanges" or as the types covered by §112(g)(1)(C) or (D). *Second Revenue Act of 1940:* H. R. REP. No. 2894, 76th Cong., 3d Sess. (1940) 30; SEN. REP. No. 2114, 76th Cong., 3d Sess. (1940) 18; *id.*, Pt. 2, p. 16; CONFERENCE REPORT, H. R. REP. No. 3002, 76th Cong., 3d Sess. (1940) 56. *Excess-Profits Tax Amendments of 1941:* H. R. REP. No. 146, 77th Cong., 1st Sess. (1941) 14; SEN. REP. No. 75, 77th Cong., 1st Sess. (1941) 15.

contained in Section 740(a). However, these limitations can safely be extended, and statutory amendments to that end are desirable. It is not difficult to think of other cases where Supplement A treatment is fully as justified as in the cases now within the provisions of Section 740(a). One example would be a case where particular departments of one or more corporations are split off and put into a new corporation. Another would be the case where assets are acquired for preferred stock or even long-term bonds. To cite one more example, there is no reason why a corporation acquiring the assets of a partnership should not be permitted to avail itself of the base period experience of a sole proprietorship which preceded the partnership.[64] Even if the present limits on the formal aspects of transactions eligible for Supplement A are to be retained, however, it is hard to find any reasonable justification for requiring that the exchange be tax-free in nature.

The General Operation of the Supplement

Once it is determined that assets have been acquired in a Supplement A transaction during or after the base period the goal of the statute is to combine or coalesce the earnings experience of the "acquiring" and "component" corporations for each of the base period years; and to treat the combined annual base period earnings in substantially the same manner as the earnings of a single corporation under Section 713. The general operative provisions of Supplement A, contained in Section 742, provide for computation of the average base period net income substantially as follows:

(1) By aggregating for each base period year the net income or deficit[65] of the taxpayer and of each component corporation for their respective taxable years *beginning* with or within such base period year. Under the 1942 Act the term "base period year" was permanently anchored to the four calendar years 1936-1939, and cannot, therefore, shift with changes in the taxable year of the acquiring corporation as under prior law.[66]

(2) By applying the 75% rule of Section 742(b). This rule, which is designed to bring automatic relief to corporations having an unusually poor year (usually 1938) within the base period, brings the lowest base period year up to an amount equal to 75% of the average of the other three years. The rule is not peculiar to Supplement A. It was also brought into Section 713(e) by the 1942 Act to replace a much less generous provision, applicable to prior years,[67] which merely treated the deficit

[64] In the cases mentioned, however, the possibility of relief under §722 should not be overlooked.

[65] A deficit is determined as in §713(c), *i.e.*, partially tax-exempt interest, as well as the deductions and dividends received credit, is deducted from gross income.

[66] The change is not retroactive unless the taxpayer so elects; and the amendment is not available to a taxpayer which became an acquiring corporation prior to September 1, 1940, the base period for the first taxable year ending in 1941 being applicable. Rev. Act of 1942, §228(a); INT. REV. CODE §740(d). See HOUSE REPORT, 152-153; SENATE REPORT, 217; CONFERENCE REPORT, H. R. REP. No. 2586, 77th Cong., 2d Sess. 66.

[67] The Supplement A 75% rule applies only to taxable years beginning after Dec. 31, 1941. It is not subject to the general privilege of elective retroactivity.

year (the greatest if more than one) as a year in which no profit or loss was sustained.

(3) By taking the aggregate net result for the four years and dividing by four.

(4) As an alternative to the latter two steps, Supplement A taxpayers may now use the "normal growth" formula. Prior to the 1942 Act, this privilege was limited to ordinary income credit taxpayers using Section 713. The growth formula, contained in Section 742(h), is intended to reflect the (assumed) continuation of an upward trend shown by an enterprise during the base period, and operates in the same manner as the provision for ordinary income credit taxpayers in Section 713(f).

Certain minimum limitations on the average otherwise determined under the Supplement are set by Section 742(d). This section states that the average base period net income shall in no case be less than zero. It further provides that in certain limited situations[68] the average base period net income of the taxpayer shall not be less than that of its *qualified* component having the greatest average base period net income, or that of the taxpayer computed without regard to that of any of the qualified components involved in the transaction.

Once the average base period net income has been computed under Supplement A it is converted into an excess profits credit, as in the ordinary case under Section 713,[69] by taking 95% of such amount, and then adding 8% of the net capital addition or subtracting 6% of the net capital reduction. In making the latter adjustments for net capital changes in the taxpayer, Section 743 provides for transferring to the taxpayer the net capital addition or reduction of any component corporation. The provision, of course, affects only cases where components have been acquired since the base period.[70] The section contains appropriate provisions requiring adjustment where the net capital changes of the taxpayer or a component are attributable to intercompany transactions.[71] In addition, the ordinary operation of Section 743 is subject to modification in any case calling for the application of the anti-duplication provisions of Sections 740(c) and 742(f)(1), hereinafter discussed.

Despite the 1942 amendments, one major defect remains in the provisions respecting net capital changes. Suppose the taxpayer corporation acquires after the base period, in exchange for its voting stock, the assets of a component corporation *which was organized after the base period* and therefore has no base period experi-

[68] This provision is limited to Supplement A transactions after Dec. 31, 1939. It also requires that, on Sept. 11, 1940 and at all times until the transaction, either the taxpayer or one of the qualified components involved must have owned at least 75% of the stock of the other corporations involved. The term "qualified component corporation" is defined as one in existence at the beginning of the taxpayer's base period. This relatively minor provision of the statute is the only one wherein the concept of the qualified component corporation has survived the 1942 amendments. See *infra*, p. 89

[69] As a matter of mechanics the credit is in all cases computed under §713. See §§742 (first sentence), 713(a), and 743(a).

[70] Net capital additions and reductions are defined in terms of changes since the base period. §713(g).

[71] The details of these provisions were for the most part added by the Rev. Act of 1942, §228(d). The committee reports state that the amendments were "clarifying" in nature. HOUSE REPORT, 155-6; SENATE REPORT, 221.

ence.[72] The component will contribute nothing to the taxpayer's income credit under Supplement A. Yet if Supplement A is used, the taxpayer will not be entitled to a capital addition on account of the acquisition of the assets of the component, and instead it will be given the capital addition (including the capital paid in upon the organization of the component subsequent to the base period) of the component—which may vary widely from the assets held by the component at the time of absorption.[73] The purpose of the provision is only to prevent a double use of income from the component's assets, first through the Supplement A average base period income and then through a capital addition on the acquisition of the component's assets. In the example given, no such duplication can occur, and if the section is applied as indicated, a distortion is inevitable.

Special Problems in Computing Base Period Net Income: Fiscal Years, Short Years, Vacant Years, and General Relief

The foregoing discussion of the procedure for computing average base period net income under Supplement A has, by and large, assumed that each corporation involved has a readily determinable earnings experience for each of the base period years, at least until the time of the Supplement A transaction. This assumption avoids several complex problems. One difficulty under prior law has been mentioned —the possible shifting of the base period years, which has been avoided by the 1942 amendments.[74]

In addition, the 1942 Act made several other corrections with respect to the base period income taken into account. Under prior law, the income of an acquiring corporation, and its components, included in Supplement A average base period net income was limited to that earned in their respective taxable years beginning after December 31, 1935, *and ending* with or within the acquiring corporation's base period years; and the income of a component prior to the beginning of the taxpayer's base period was also excluded. This rule was unsound in various situations. For example, if the taxpayer's base period was the period of four calendar years 1936-1939, the old rule excluded in the case of components using a fiscal year in the base period, both the income earned in 1936 until the close of the fiscal year beginning in 1935, and that earned in 1939 after the close of the fiscal year beginning in 1938. Only three years were thus reflected in the average.[75] The new rule includes for each base period year all taxable years of the taxpayer and its components *beginning* with or within such base period year. This provision may work to the tax-

[72] Or which has lost its base period experience to another corporation of which it has previously become a surviving component. §740(c), hereinafter discussed.

[73] Thus assets acquired by the component for bonds, and then acquired in turn by the taxpayer for its stock when it absorbed the component, would not be reflected.

[74] See note 66, *supra*.

[75] For an excellent discussion and analysis of the incongruities resulting from the defective provisions of the original law, discussed herein, see ALVORD, A PRELIMINARY ANALYSIS OF THE EXCESS PROFITS TAX OF 1940 (1940) 66-69.

payer's advantage where a fiscal year began late in 1939 in that a business uplift in 1940 may be partially reflected in the income credit.

Despite the above changes in the statute, questions arise where the taxpayer or a component has a short year, and possibly two taxable years, beginning in the same base period year. The problems are complex and have been largely left to be dealt with by the regulations.[76] In general, the regulations prescribe the use of daily averages prorated for a twelve months' period, except where it can be clearly shown that actual experience over such a period yields a fairer result. However, the regulations, like the statutory provisions for normal growth in Sections 713(f)(7) and 742(h)(2), permit no use of experience after May 31, 1940.

Other difficult problems are presented where the taxpayer or a component or both were not in existence during one or more base period years. Under the original law, the "vacant year" problem was largely by-passed by reason of the arbitrary limitations on the inclusion of base period experience. These limitations contained in the law prior to the 1942 Act, required the following results: (1) only the base period experience of "qualified" components, that is those in existence at the beginning of the base period, could be taken into account;[77] (2) even the experience of a component which was qualified only by reason of having itself acquired a component which was actually in existence at such time was includible only for the period subsequent to the acquisition of such component;[78] and (3) the income of an acquiring corporation for the period prior to its becoming an acquiring corporation (if it was not actually in existence at the beginning of the base period) was likewise excluded.[79] These were errors of draftsmanship in the Second Revenue Act of 1940, resulting from the failure to keep the Supplement in harmony with the rest of the bill as its basic policy was changed in the course of its passage.[80]

The 1942 Act, as stated above, corrects these errors to the extent of allowing the inclusion of all excess profits net income of both the acquiring corporation and its components for their respective taxable years beginning in the base period. Moreover, for those base period years in which *neither* the acquiring nor any component corporation was in existence, a constructed income based on 8% of invested capital of each corporation as of the beginning of its first taxable year beginning in 1940, is allowed.[81] Adjustments are prescribed, pursuant to regulations, to prevent the

[76] INT. REV. CODE §742(a), last paragraph; U. S. Treas. Reg. 109, §30.742-2(b)(3)(ii)(A).

[77] §742(a)(2) of prior law. A component not actually in existence on such date, but which had absorbed a component having such existence, was also "qualified." See old §740(f).

[78] See old §742(f)(2).

[79] See old §742(f)(1).

[80] The House version of that bill had required actual existence at the *beginning* of the base period as a prerequisite to any corporation's use of the income credit; and the Senate changed this requirement merely to existence *prior to January 1, 1940,* allowing a constructed income for the vacant period. The Senate prevailed. See H. R. REP. No. 3002, 76th Cong., 3d Sess. (1940) 47; INT. REV. CODE §712(a). But Supplement A was not revised to bring its limitations in line with this change in policy.

[81] Rev. Act of 1942, §228(c); INT. REV. CODE §742(e). This constructive income is available only if none of the corporations was actually in existence on Dec. 31, 1936. Corporations absorbed as components prior to the beginning of their acquiring corporation's first taxable year in 1940 are not included in the adjustment directly, since their assets will be included through the acquiring corporation.

doubling up of invested capital for purposes of computing the constructed income, on account of the cross ownership of stock between the corporations involved.[82]

This "fill-in" of vacant periods is unduly limited, if consistency with the constructive income afforded by the general provisions for the income credit is desired. The Act does not allow a fill-in under Supplement A of a vacant period of any of the corporations in any base period year in which any one of the taxpayer and its component corporations was in existence. This appears to be an arbitrary rule. Obviously, the fill-in, as in the case of the non-Supplement A taxpayer, should be for the entire vacant periods of all corporations absorbed into the system.[83]

Still another problem in computing base period income to which the 1942 Act supplied at least a partial answer is that of the relationship between Supplement A and the general relief provisions of Section 722. Prior law did not cover the point, but the 1942 Act[84] added a provision to Section 722 which states that—

(e) Rules for Application of Section.—For the purposes of this section. . . .

(2) in the case of a taxpayer, the average base period net income of which is computed under Supplement A, for the period for which the income of any other person is included in the computation of the average base period net income of the taxpayer, the taxpayer shall be treated as if such other person's business were a part of the business of the taxpayer.

A ruling issued by the Commissioner in explanation of this provision acknowledges that Supplement A and Section 722 relief are not mutually exclusive.[85] It seems clear that Supplement A may be used in conjunction with reconstructed base period income for an acquiring corporation or any one or more of its components or both. However, the approach of the Commissioner will be to look at the enterprise as a whole in determining the amount of relief which will be granted; and the

In constructing the income, an inadmissible asset adjustment based on the last year beginning in 1939 is made, including the assets taken over from any component during the year, as well as those remaining from previous acquisitions of components. Where an acquiring corporation absorbs a component after such day but within the component's last taxable year beginning in the base period (*i.e.*, in 1939), the *component's* income in the vacant period is similarly constructed as of the day it was taken over.

[82] §742(e)(3); U. S. Treas. Reg. 109, §30.742-2(d). For an example of the operation of this provision, see Rev. Act of 1942, CONFERENCE REPORT, 66-67. Note that the examples given in the House Report (pp. 154-155) and the Senate Report (p. 220) are covered by the new §742(f)(1), discussed below.

[83] It may have been thought that the absorption of an additional corporation into the system after the basic corporation had been organized, is analogous to a capital addition during the base period, and consistently with the rule with respect to capital additions, the income prior to the absorption or addition should not be built up. The difficulty with this reasoning is that the rule with respect to capital additions is also unsound, in light of the purpose to reflect in the credit the normal profits of the business as it existed at the beginning of the excess profits tax, with adjustments for capital changes thereafter. Note, however, that the provision for putting a short year on an annual basis will fill in some vacant periods. See p. 89, *supra*.

[84] §222(a). This amendment like all amendments to §722, is applicable to all taxable years beginning after Dec. 31, 1939. §222(e)(1).

[85] I.T. 3617; I.R.B. 1943-15-11502. The whole matter had been thrown into confusion by an earlier ruling, issued after the passage of the Rev. Act of 1942 and purporting to deal with 1942 and subsequent years, but apparently based solely on prior law. I.T. 3585, 1942-2, C.B. 158. This ruling had concluded that "Section 722 of the Internal Revenue Code is designed to afford relief in the case of certain situations not covered by other sections of the Code."

ruling states that the statutory provision does not necessarily work in favor of the taxpayer in all cases:

> Section 722(e)2 of the Code, as amended, will also operate to deny the relief to an acquiring corporation entitled to such relief prior to a merger where the inclusion of the component corporation's business as its own will render the tax computed without the benefit of the general relief section fair and nondiscriminatory.

Section 742(f)(1): The General Provision Against Duplication

The foregoing discussion of the procedure for computing average base period net income under Supplement A is subject to possible qualification in any case where, prior to the Supplement A transaction, the acquiring corporation has acquired stock of the component corporation by giving up assets rather than by issuing its own stock in exchange therefor. In such cases the Commissioner is given very broad authority to issue detailed regulations to prevent possible "duplication" of base period experience by reason of the fact that assets have left the corporate system.

The statutory provision, added by the 1942 Act,[86] is brief and contains almost nothing in the way of standards or guides to limit the Commissioner's regulatory power thereunder. Indeed it is only by referring to the committee reports that one learns that the purpose of the section is to prevent "improper duplications of base period income and capital additions and reductions."[87] The statute merely provides in substance that if, after December 31, 1935, the taxpayer has acquired stock in another corporation, and thereafter such other corporation becomes a component of the taxpayer—

> then to the extent that the consideration for such acquisition was not the issuance of the taxpayer's . . . own stock, the Supplement A average base period net income of the taxpayer shall be reduced, and the transferred capital addition and reduction adjusted, in respect of the income and capital addition and reduction of the corporation whose stock was so acquired . . . in such amounts and in such manner as shall be determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary.

Such adjustments are also to be made—

> . . . in respect of the income and capital addition and reduction of any other corporation which at the time of such acquisition was connected directly or indirectly through stock ownership with the corporation whose stock was so acquired and which thereafter became a component corporation of the taxpayer. . . .

It should be noted that while Section 742(f)(1) comes into play only where stock is acquired for a consideration other than the issuance of stock in exchange therefor after December 31, 1935, the connection "directly or indirectly through stock owner-

[86] §228(c). If the section had a functional forebear in prior law, it was old §742(e)(1), dropped in the 1942 amendments. This section was a weak attempt at eliminating duplication, but was meaningless since it dealt with intercorporate dividends, which were not included in excess profits net income.

[87] HOUSE REPORT, p. 1550; SENATE REPORT, p. 220; CONFERENCE REPORT, p. 35.

ship" is subject to neither of these limitations as to time or manner of acquiring ownership.[88]

The remainder of Section 742(f)(1) consists of a qualifying sentence which states that stock shall be deemed to have been acquired in consideration of the issuance of the taxpayer's stock (and thus taken out of the scope of the section) where it has in the hands of the taxpayer a basis determined with reference to the basis of stock previously acquired by the issuance of the taxpayer's own stock. The general rules above stated, and this qualification, apply equally in the case of multiple Supplement A transactions, *i.e.,* where one corporation has after December 31, 1935, acquired stock in another corporation and thereafter both corporations become components of the taxpayer.

Analysis of the brief statutory language raises a host of questions, some of which are left without a satisfactory answer even by the detailed regulations. Before exploring the complexities, however, it may be well to look at the relatively simple basic theory underlying the section, as amplified by the regulations.

The basic theory of the regulations may be illustrated by the following example. Suppose, to keep the case simple, that corporations *A* and *B* are both in existence on January 1, 1936, are on a calendar year basis, and are in no way connected by stock ownership. On December 31, 1937, *A* purchases all the stock of *B* from *B's* stockholders for cash or other assets. The two corporations then continue in existence until at some later date, say on December 31, 1940, *B* is liquidated or merged into *A*. In the absence of Section 742(f)(1), *A* would for 1941 and subsequent years be entitled to compute its Supplement A average base period net income by adding together the separate earnings of *A* and *B* for each of the four years 1936-39. This result, however, would be open to the following criticism:

For the years 1936 and 1937 the combined average base period net income of *A* and *B* would represent the amount earned on assets in excess of those now held by *A,* the difference being caused and measured by the amount paid "out of the system" by *A* to the stockholders of *B* on December 31, 1937. If it may be assumed that the assets thus given up contributed to *A's* earnings in the years 1936 and 1937, then it seems only fair to make some corresponding downward adjustment in the combined earnings of *A* and *B* for 1936 and 1937 before allowing them to enter into *A's* Supplement A income credit.

If a strictly logical course were followed, a detailed factual investigation might be made as to the extent, if any, to which the assets given up contributed to *A's* income in 1936 and 1937, and the amount of such income would be eliminated from *A's* Supplement A average base period net income. This procedure, however, would in many cases involve such difficult and probably unanswerable questions as to make such a rule impossible to administer. The Commissioner has instead adopted a rule of thumb, which like all rules of thumb is doubtless intended to do rough justice

[88] This seems reasonably clear from the statutory language, and the regulations so state explicitly. See p. 93, *infra,* note 94.

for the sake of administrative expediency. He starts with the assumptions, first, that the assets in question have contributed to *A's* base period earnings and, second, that a fair approximation of the amount of such earnings may be found in the figure for *B's* earnings during the years prior to the stock acquisition by *A*. Although these assumptions are not explicitly stated in the statute, committee reports, or regulations, they appear to constitute the basic rationale of the regulations, and perhaps of the statute.[89] On these assumptions the rule prescribed by the Commissioner is that, in the case stated above, the earnings of *B* for the two years, 1936 and 1937, prior to the acquisition of *B's* stock by *A*, are to be eliminated.

Although in practice a 742(f)(1) transaction probably will not be as simple as the example given above, the basic method as prescribed by the regulations is the same in all cases.[90] Reference should be made to the discussion and examples given therein[91] in cases involving fiscal years and "vacant" years in the base period, acquisitions during a taxable year, acquisitions after the base period,[92] partial and piecemeal acquisition of stock, several classes of stock of the component, capital additions and reductions, and multiple Supplement A transactions.

Space prevents detailed analysis of these provisions but some idea of the pervasive operation of the section in the more complex situations may be gained from the examples involving multiple Supplement A transactions together with the "stock ownership" clause.[93] These examples establish the following rules:

(1) If the taxpayer, *A*, acquires stock of a component, *B*, other than by the issuance of stock of *A*, not only is *B's* experience prior thereto excluded from *A's* Supplement A average base period net income, but so also is that of any corporation, *C* (which later becomes a component of *A*), in which *B* owns stock at the time and in the proportion in which *B* holds such stock.[94] Moreover, it is immaterial how or when *B* acquired such stock, *i.e.*, whether *B* acquired such stock in a 742(f)(1) transaction.

[89] The committee reports speak of eliminating "*experience attributable to stock* acquired by the transfer of assets, which assets thereupon went out of the system" (CONFERENCE REPORT, 67), and "base period income and deficits for the base period years before the acquisition of such stock which is attributable to such stock. . . ." SENATE REPORT, 221; HOUSE REPORT, 155.

[90] With one apparently erroneous exception. See note 92, *infra*. Another inconsistent case originally contained in the regulations has been changed. See note 93, *infra*.

[91] Section 742(f)(1) is treated generally in the regulations at §30.742-2(b)(3)(ii)(B). "Vacant years," however, are treated in §30.742-2(d), and capital changes in §30.743-2(b).

[92] See regulations, examples involving corporations J through M. The rule prescribed is to eliminate a portion of the experience of the year in question proportionate to the number of days of the year prior to the acquisition. This would seem erroneous where stock is acquired after the base period. See example (3) involving corporations L and M. The proper result, in the light of the general approach of the regulations would seem to be to eliminate *all* M's base period experience in the year of acquisition as well as in later years.

[93] The examples referred to are those dealing with corporations numbered R through Z in the regulations, §30.742-2(b)(3)(ii)(B), as amended by T.D. 5289, Aug. 7, 1943. The main example replaced by T.D. 5289 was erroneous, in the light of the principles generally followed in the regulations.

[94] This statement embodies the rules illustrated now by the two examples involving the R, S, T, and U corporations. It is inconsistent with the former example (1) involving the R, S, and T corporations which appeared in the regulations prior to their amendment by T.D. 5289. See note 93 *supra*.

(2) In addition, even where *A* acquires stock of *B* by the issuance of its own stock, if *B* acquires the stock of *C* in a 742(f)(1) transaction (and both *B* and *C* become components of *A*), *C's* experience prior to such acquisition by *B* is excluded from *A's* Supplement A average base period net income. This is true even though *B's* acquisition of *C* stock is later than *A's* acquisition of *B* stock.[95]

So much for the mechanics of 742(f)(1) as it has been interpreted by the Commissioner's regulations. The important thing to note about the Commissioner's handiwork as a whole, however, is that it consists almost entirely of mechanics. Although the committee reports make it clear that the Congressional purpose is to eliminate duplication of base period experience, the Commissioner's exercise of regulatory power is not limited to cases where duplication is in fact found to result,[96] nor even to cases where the absence of duplication cannot be clearly demonstrated. The regulations explicitly acknowledge the Congressional purpose, but they flatly state that the adjustments indicated by the examples given therein are to be made in all cases. The underlying principle of preventing duplication is not a limitation on these operative rules, but has the effect of extending such rules "to all other cases to which Section 742(f)(1) may be applicable, in a manner consistent with the principles underlying such described cases."[97] The regulations require a showing of actual duplication only in the limited type of case where *A* acquires *B's* stock directly from *B* rather than from *B's* stockholders. In such a case no assets go out of the corporate system and therefore no duplication results.[98]

It is, however, perfectly possible for A to acquire stock of *B* from *B's* stockholders without giving up income-producing assets, and without resulting in duplication. For example, suppose *A* buys stock of *B* with cash it has just acquired by the issuance of stock, or indeed any idle cash which it has not been employing in its own business (and which does not result from the sale of assets the earnings of which were reflected in base period income). Or suppose *A* acquires stock of *B* by issuing long-term bonds.[99] In such a case it is obvious that no assets have left the system, and that the same earning power remains in the combined corporate enterprise of *A* and *B* as before.[100] Another case which is apparently subject to a

[95] See example dealing with corporations W, X, Y and Z, added by T.D. 5289.

[96] See U. S. Treas. Reg., §30.742(b)(3)(ii)(B), first paragraph.

[97] *Ibid.*

[98] The case would be different of course, and the section might properly apply where *A* acquires stock of *B* which *B* has just purchased from its own stockholders. In such case, the purchase would be from *B* itself in form only.

[99] The examples given by the regulations refer uniformly to acquisitions for "cash," or "assets," rather than, in the words of the statute, acquisitions other than by the issuance of stock. However, it is doubtful that this variance can be relied upon. The regulations also refer to acquisitions by the taxpayer "for assets (other than its own stock)."

[100] It might be argued that the inequity of applying §742(f)(1) where stock is purchased for bonds is in some measure compensated for by the fact that the taxpayer gets the benefit of an interest deduction. This argument would lose force, however, where the purchase of stock for bonds takes place in the base period and the base period earnings are also thus reduced. Moreover, any benefit derived from adding an interest deduction after the base period might not be peculiar to Supplement A, but might simply represent an advantage possessed by any income credit taxpayer which, after the base period,

742(f)(1) adjustment but which would not result in duplication is the situation where the consideration given by *A* consists of stock of domestic corporations held by *A* throughout the base period. The dividends on such stock, being excluded from excess profits net income, would not have added to *A's* earnings credit.

Another problem might be raised by contributions to capital. Suppose *A*, owning the stock of *B* and *C*, contributes its holding of *C* stock to *B*, and thereafter *C* is merged into *B*. In such case the acquisition by *B* is clearly by a means other than the issuance of its own stock; yet it is equally clear that no assets have left "the system" composed of *B* and *C*. It is believed, however, that the improper result of a 742(f)(1) adjustment is prevented by the literal wording of the statute. The section calls for an adjustment "to the extent that *the consideration* was not the issuance of the taxpayer's . . . stock." In the case of contributions to capital there is of course no consideration given by the transferee corporation.

On the other hand, the literal wording of the statute would appear to permit the Commissioner to require an adjustment where stock of a component is acquired in exchange for *treasury* stock of the acquiring corporation, since the statute speaks of the "issuance" of stock of the latter. To the extent that the treasury stock was in turn acquired by the taxpayer by giving up assets an adjustment would, at least superficially, seem proper. But the automatic 742(f)(1) adjustment will not work out consistently with the basic method of the regulations where the treasury stock was bought in by the taxpayer well before the end of the base period and well before the subsequent exchange of treasury stock for stock of the component. Duplication would take place only with respect to the period up to the time of the acquisition by the taxpayer of its treasury stock, not the time of the subsequent exchange. However, the regulations do not touch on the problem at all.[101]

Many other cases of improper results and of unanswered questions, having tremendous dollars and cents consequences to corporations which happen to fall one side or the other of the arbitrary rules, will arise under the existing regulations. Some instances of occasional injustice are naturally to be expected wherever a rule of law takes the form of an arbitrary rule of thumb. In some fields of law

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issues bonds and does not receive in return assets that earn more than the interest, or a taxpayer that recapitalizes after the base period by issuing bonds for its own outstanding stock. With respect to such a recapitalization, the statute does not seem to furnish clear evidence as to whether the benefit of the interest deduction would be offset by a capital reduction; and the answer may depend upon whether the recapitalization is a tax-free reorganization. *Cf.* §713(g)(4); Le Tulle v. Scofield, 308 U. S. 415 (1940); Clarence J. Schoo, 47 B.T.A. 459 (1942) (Non-acq.), *aff'd and dismissed*, C.C.A. 1st, March 29, 1943; Edgar M. Docherty, 47 B.T.A. 462 (1942) (Non-acq.), *remanded*, C.C.A. 1st, Jan. 12, 1943.

[101] A taxpayer in such a position would probably do well to argue under the existing regulations that only an adjustment for the shorter period is "consistent with the principles underlying . . . described cases." *Cf.* U. S. Treas. Reg., §30.742-2(b)(3)(ii)(B), first paragraph. However, resistance will probably be encountered from the Commissioner; for this catch-all provision appears to contemplate only "the adjustment under section 742(f)(1)," which presumably is the indiscriminate elimination of all experience of a component prior to the acquisition of the component's stock. A recent case decided by the Tax Court would support the Commissioner's argument that there is no "issuance" where treasury stock is used. *Firestone*, 2 T. C. —— No. 105, Sept. 20, 1943, C. C. H. Dec. No. 13,520 (involving Code, §113(a)(7)).

this is considered a fair price to pay for certainty. Familiar examples are to be found in statutes of limitations, statutes of frauds, zoning regulations, and the like. It is submitted, however, that in the highly delicate and complicated problems to which Section 742(f)(1) was directed, the regulatory straitjacket is impossible to justify on any grounds of certainty or administrative expediency. It was precisely because the problems were complex that rigid statutory rules were eschewed in favor of the supposed virtues of administrative flexibility.[102] Unless the Commissioner adopts a different approach, therefore, it would seem that the only solution to the inequities that will inevitably result, and the only fair way of achieving the basic objective, is through further legislative action. Such action should ensure at the minimum that taxpayers will be given an opportunity to avoid the 742(f)(1) adjustment where they can show that duplication does not in fact exist.

Section 740(c): Surviving Components and Related Problems Requiring the Elimination of Duplication

Under the law prior to the 1942 Act, opportunities for duplication of earnings experience were not limited to cases where an acquiring corporation gained another's credit by giving up its own income-producing assets. Further opportunities arose from the fact that the draftsmen of the original act apparently lost sight of the component corporation once they got it up to the point of a Supplement A transaction. They seem to have focussed their attention exclusively on the main objective, that of giving to a corporation which acquires another's assets the *past* earnings experience that "belongs" with them, so to speak. No provision was made for taking this experience away from the component; and it was evidently overlooked that the component might continue in existence[103] or, where the component was a substantially wholly-owned subsidiary, might transfer its income credit a second time when liquidated into its parent.[104]

The resulting possibilities for duplication in the use of a component's experience were, at least theoretically, quite remarkable. Let us suppose that *A* acquired *B* on December 31, 1938 in a 740(a)(1)(A) transaction, and that *B,* instead of liquidating, used the consideration received from *A* to purchase new assets and continued in existence for the remainder of the base period. *A* would quite properly get *B's* earnings experience prior to December 31, 1938. *B* would, also quite properly, be given the earnings experience of its new assets for the period from December 31, 1938 to the end of the base period.

However, *B* would also still be allowed to use the experience attributable to its old assets prior to their transfer to *A;* and, if *B* should subsequently become a com-

[102] See committee reports, note 87, *supra*. In fairness to the Commissioner, it should be noted that the reports also furnish some basis for the use of the *general type* of automatic adjustment embodied in the regulations. See note 89, *supra*.

[103] In cases under §740(a)(1)(A).

[104] The liquidation (which is in fact required under §§740(a)(1)(B) and (C)) itself qualifies as a Supplement A transaction under §740(a)(2).

ponent of another corporation, *C*, the latter would inherit this same base period experience. In addition, *A* would literally be allowed to use the earnings experience of *B* after December 31, 1938, which was attributable to the new assets never at any time possessed by *A*. The incongruous results might multiply as complexities and variations enter the picture. For example, either *A* or *B* might have further Supplement A transactions of the same sort; and any of the transactions might occur either during the base period or thereafter.

The obviously unsound results just indicated have been cured by the new Section 740(c), added by the 1942 Act.[105] Although the new section is cloaked in language as forbidding and involved as any that can be found in the law, its effect can be expressed in a simple basic principle, namely that earnings experience shall follow from corporation to corporation the group of assets to which it is attributable. This principle has been embodied in three main rules which, leaving aside qualifications and exceptions, provide as follows:

(1) If *B* becomes a component of *A*, *B* may not thereafter use its earnings experience prior to the day of the transaction.[106]

(2) However, in computing *B's* tax for its taxable year during which the transaction occurred, *B* may use a portion of its earnings experience, pro-rated according to the number of days in its taxable year prior to the transaction.[107]

(3) *A* does not get the benefit of any of *B's* earnings experience subsequent to the transaction.[108]

The first two rules, limiting the credit available to the component, apply by their terms only to taxable years beginning after December 31, 1941. The third rule, limiting the credit of the acquiring corporation, applies to all taxable years beginning after December 31, 1939.[109] Thus none of the provisions of the new section are subject to the general election as to retroactivity of the 1942 amendments.

Looking more closely to the details of the statutory language, we note that the basic rule for limiting the credit of the component—rule (1) above—applies equally to any other corporation[110] which either immediately[111] or at some later time

[105] §228(a). The former §740(c), defining a "qualified component corporation," was eliminated.

[106] INT. REV. CODE §740(c)(1). This section is subject to qualification by the rule of §740(c)(2), immediately following.

[107] *Id.* §740(c)(2). This rule may apply whether or not the component is immediately liquidated. See note 111, *infra.* Although *B* thus is permitted a portion of its earnings experience, it does not take account of any of its capital addition or reduction attributable to the time immediately before the transaction. SENATE REPORT, 217; HOUSE REPORT, 152.

[108] INT. REV. CODE §740(c), last sentence. This rule by its nature can apply only where the transaction occurs during the base period and the component continues in existence.

[109] Rev. Act of 1942, §228(f).

[110] The language of the statute is "an acquiring corporation of which the acquiring corporation in such transaction is not a component." This makes clear that although the second acquiring corporation ordinarily is excluded from using the experience of the component, this would not be true where the second acquiring corporation acquires, or has acquired, the first acquiring corporation.

[111] Section 740(c) is not limited to cases of surviving components, but may include exchanges which are required by §740(a) to be followed by liquidation of the transferor. See SENATE REPORT, 215; HOUSE REPORT, 151. Thus the transfer by a wholly-owned subsidiary of all its assets to a corporation

acquires the component in a Supplement A exchange. Moreover, if *B* itself had components prior to its transaction with *A, B* loses their experience as well as its own. This result is of course consistent with the basic principle of the section, since such experience is all given to *A*.[112]

The basic rule of Section 740(c)(1) does not apply where the growth formula is used, except for purposes of limiting the average base period net income by the net income of the best base period year. Thus, while the component in effect gets a substitute[113] for the earnings experience given to the acquiring corporation, the latter exception means that the component's income credit is limited by its best year subsequent to the Supplement A exchange.

With respect to the operation of rule (2), applying to the computation of the tax for the year of the Supplement A exchange, it is to be noted that the rule—when taken together with Section 742(f)(2), the analogous provision for acquiring corporations—does not simply slice a single credit into two parts. Such a result is achieved only where the taxable year of both corporations covers the same period and where both corporations continue in existence throughout such year. The component's earnings experience in other cases may in a sense do double duty, though without improper duplication. This follows from the fact that both corporations receive a portion of the experience, according to the number of days in their respective taxable years which is determined separately for each corporation before and after the transaction, respectively.

Thus for example suppose the component, *B,* continues in existence, after a Supplement A exchange transferring its assets to *A* on June 30, 1943, and that *A's* taxable year begins June 1st and *B's* March 1st. For its taxable year from March 1, 1943 to March 1, 1944, *B* would be allowed to use roughly ⅓ of its base period experience. *A,* on the other hand, would be allowed in its taxable year from June 1, 1943 to June 1, 1944 to use roughly 11/12 of *B's* experience. These results are of course proper since in each case they represent the portion of the respective taxable years during which the assets are held.

In cases where the component goes out of existence immediately after the Supplement A transaction, it is not deprived of *any* of its base period income in computing its tax for the year of the transaction. Thus if *B,* on a calendar year basis transferred all its properties to *A* on June 30, 1943 and was forthwith liquidated, its taxable year 1943 would be from January 1st to June 30th. The number of days in the taxable year prior to the transaction (181) would be the same as the total

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other than the parent, in exchange for voting stock, followed by a liquidation of the subsidiary by the parent, would not transfer the income experience of the subsidiary to the parent. Such experience would belong exclusively to the transferee of the assets. Similarly, a corporation completely liquidated but not dissolved would not, if revived by new capital, retain the base period income passed on to an acquiring corporation immediately prior to the liquidation.

[112] INT. REV. CODE §§740(g), 742(a).

[113] With this possible exception, no provision is made for giving the component a substitute to fill in the portion of its base period the earnings experience of which is exclusively given to the acquiring corporation. See p. 99, *infra*.

number of days in the taxable year; and therefore the application of the prescribed ratio would give *B* 100% of its base period net income. *A,* if also on a calendar year basis, would nevertheless be allowed, under Section 742(f)(2), to use approximately one-half of *B's* base period income in computing its tax for 1943 under Supplement A. The results are again perfectly proper since *A* will have the income from the assets for half the year, and *B* is required to annualize its excess profits net income in computing its tax.[114]

The new provisions of Section 740(c) can as a whole fairly be said to have achieved their objective of ensuring that earnings experience follows assets. But while the section thus deprives a surviving component or its successors of past base period experience attributable to the transferred assets, it stops there and makes no provision for a substitute, except by the use of the normal growth formula.[115] No automatic "fill-in" with constructed income based on invested capital is available, since such fill-ins are granted only for periods during which a taxpayer is "not in existence."[116]

It would seem that the Commissioner might rectify this *casus omissus* in the statute through the general relief provisions of Section 722. In such event, the measure of the constructive income would properly seem to be not less than the earnings of the assets newly acquired by the surviving components during the period, if any, when they were operated by the former owner. But the assets may of course have no history of former operation; and, in any event, the applicant for relief under Section 722 cannot feel secure in the belief that it will automatically[117] get the full measure of replacement of its earnings credit to which it would be entitled if provision had been made in the statute, allowing, for example, the use of fill-ins under Sections 713(d)(2) or 742(e). Save for the possible benefits of Section 722, the surviving component appears under the present provisions of law to have only the alternatives of the invested capital credit or an amputated income credit.

III. CONCLUSION

The foregoing discussion describes in some detail the operation of the provisions controlling the excess profits credit consequences of corporate readjustments. A brief but more general word should be said as to the adequacy of these provisions. The difficulty of ascertaining the rule of the statute and translating it into dollars of credit, is by no means the most serious complaint which taxpayers (and Bureau examiners) are entitled to register. That problem (when tied in with the rest of the excess profits tax structure) requires, more or less, infinite patience with the obstacles created by sheer intricacy of expression; a student's enjoyment of the sub-

[114] INT. REV. CODE §711(a)(3). The result as to *B* is explicitly recognized by the regulations. U. S. Treas. Reg. 109, §30.740-2(c)(3).

[115] See note 113 *supra*.

[116] INT. REV. CODE §§713(d)(2) and 742(e).

[117] The Commissioner has indicated that he will not acquiesce in any 722 claim merely because grounds for relief and the proper measure of reconstruction are clearly demonstrated. He feels free to make wide use of what might be termed equitable offsets, such as for example "above normal earnings" in other years. See U. S. Treas. Reg. 109, §722-2(b)(2); and *cf. I.T. 3617*, quoted at p. 91, *supra*.

ject; an expert application of the technique of statutory construction; a knowledge of the painful growth of our tax legislation through its twenty-odd statutory revisions; a grasp of hundreds of legal principles decided, half-decided, twisted or ignored in the thousands of tax decisions handed down by too many courts of law having tax jurisdiction; familiarity with thirty years of income tax administration by the Bureau; the development, step by step, of the business since its inception, including the financial history of its predecessors—although this will often be tantamount to a review of half a century of business activity; the tax biography of the business for the same period; a corps of fact-finding and mathematical personnel; a seer of the future success of the enterprise; and many things more elusive which might seem even less credible on paper. On top of this, it may be necessary to thread the maze of the consolidated returns regulations!

There are, however, curious people who will devote their time and abilities to problems of this sort; and the common wilderness into which both government and taxpayer investigations and analyses ultimately trail off draws a practical line on the theoretical reaches of the problems. Consequently, a solution—some solution—is reached. When the final computation is made, however, the taxpayer may frequently well question what the figure arrived at has to do with an amount reflecting the "fair," "normal," or "non-excessive" earning power of the enterprise. The answer must often be that we have created an amazingly complex, uncertain, finespun, highly theoretical and frequently capricious legal structure, superficially adhering closely to a rational scheme, but in terms of practical results, frequently achieving as much nonsense as could be imagined.

A moment may be spent in searching the cause. One basic ill is the failure to make a clean break with the past. No field of our law has been as unsatisfactory as the treatment of "reorganizations" for income tax purposes. Instead of having wisely devised a method of avoiding the manifold problems of that segment of the law, we have eagerly perpetuated and magnified their importance—particularly the more dubious aspects which have remained in a state of flux throughout twenty years' experience with them.

We have already seen how crucial is the question, upon a corporate readjustment, whether a "reorganization" occurs. If a carry-over basis is applicable, the various invested capital rules of Section 760 come into play. On the other hand, if the transaction fails to meet the income tax requirements of a carry-over basis, the special provisions relating to corporate readjustments will normally not apply, and in such case the general rules of Section 718 will control invested capital. This normally means that the value of the transferred property, rather than its old basis, will be the measure of invested capital. Needless to say, a wide difference may exist between those two figures. Similarly, the application of Supplement A, rather than a mere capital addition adjustment, may depend on meeting this "reorganization" definition.

Little knowledge of our "reorganization" tax law is required to realize that it is often largely fortuitous whether a "reorganization" occurs, and that more or less minor variations in several plans of reorganization (the differences having sound business or practical justifications, but no conceivable relationship to rational taxing policy) may therefore produce widely different excess profits tax results. The recent *Southwest Consolidated* and *Alabama Asphaltic* cases[118] reveal the capricious grounds on which income tax distinctions are made in determining whether or not a "reorganization" occurs. These opinions indicate that an incidental factor, such as the issuance of a few stock warrants, or the assumption of a liability which arose in the course of reorganization, may be sufficient to disqualify the transaction under the reorganization provisions—although it may be the truest kind of business reorganization.

The inadequacy and unrealistic operation of the "reorganization" provisions of Sections 112 and 113 are well known; and their functioning is open to common and justifiable criticism even when limited to the narrow problem of determining only when taxable gain or loss is realized. It is much more difficult to justify increasing the burden of such legislation to the point of controlling a substantive matter of such importance as the excess profits credit.

Even assuming the desirability of tying in with the income tax provisions, the excess profits tax provisions controlling corporate readjustments may be further criticized for not having been worked out in a harmonious and consistent pattern. In this connection a good example is the treatment of deficits for invested capital purposes which is more specifically discussed above. The general provisions of Section 718 are supposed to embody the basic policy of the "deficit rule," that is, a deficit in earnings does not reduce invested capital. However, Section 760 has been so constructed as to "squeeze out" the deficit if a corporate readjustment occurs. On the other hand, the rules of Section 718 with respect to "identity" reorganizations seek, in a half-hearted way, to counteract this effect by restoring the deficit. As a final twist, the provisions of Section 761, which involve precisely the same deficit problem on corporate readjustments by way of inter-company liquidations, merely ignore the problem.

Another weakness in the statutory structure—despite the fact that it reflects an effort to prescribe a detailed and complete, even though highly theoretical and technical, pattern for determining the effects of a corporate readjustment—is that it nevertheless provides no rule at all (other than the implication of the general rule) for large segments of the problem. Consider, for example, the effect on invested capital of a reorganization within the framework of the existing corporation by way of recapitalization. No mention is made in the various excess profits tax provisions of the treatment of reorganizations of this common sort. The matter is particularly acute in the reorganization of financially distressed corporations through the procedures of the Chandler Act. Indeed, there is a large gap in the income tax

[118] *Supra* note 8.

law with respect to reorganizations of this particular type. If debt structures are drastically reduced or eliminated, and the equity in the company (for what it may be worth) is turned over to the bondholders and other creditors in the form of no par common stock by way of recapitalization, what is the effect on invested capital? Has the old equity capital, previously represented by the old stock wiped out in the reorganization, disappeared for tax purposes? As a matter of technical construction, it would appear not. Is the entire amount of the debt structure now to be regarded as converted into equity capital because the interests of the erstwhile bondholders are now represented by stock—despite the fact that the capital structure for business and book purposes is radically altered from its character prior to the recapitalization? This would seem the most probable result under present law. Should not the investment in the assets surviving reorganization be in some way considered? This is probably what the law should provide as a minimum. These are questions that it is impossible to answer by reference to the tax statutes for no attempt has been made to deal with them.

On the income credit side, other (though perhaps less important) gaps have been left in the statute, which have been specifically mentioned. In addition, the solution of duplication problems under Section 742(f)(1) by legislative abdication to administrative authority, without limitation or guide of any ascertainable scope, is no less a failure to meet an important problem.

Finally, a very close examination of any of the provisions relating to corporate readjustments clearly reveals that their detailed approach is illusory and deceptive. Although they at first appear to have deliberately covered by specific provision virtually all the problems involved, it soon develops that they in fact have created or failed to consider many more problems than would appear on the surface. Numerous examples of this type of weakness have already been stated.

The solution? Perhaps there is none. Knowing the high technical ability and conscientious bent of both the policy-makers and draftsmen who have produced the excess profits tax law, it is not easy to say that a better product ought to have been forthcoming. The only answer, it seems, lies in maintaining a continous process of ferreting out specific weaknesses, and willingly recognizing and acting upon the necessity for suitable remedies.

ACCOUNTING PROBLEMS UNDER THE EXCESS PROFITS TAX

Walter A. Cooper*

A prominent jurist has said that taxation is an eminently practical subject—to which statement accountants add "Amen." Too often, however, our legislators, jurists and administrative authorities pay lip service to the ideal and promptly forget it in practice. Perhaps that is too broad a statement. It may, in many cases, correctly describe the result but not the attempt, because often the accounting problems or difficulties are neither visualized nor appreciated. It is understandable that such a result may be reached by those who are not, in any way, acquainted with accounting difficulties which arise in attempting to apply statutory concepts, ideal in nature, to what might be termed "fluid" accounting principles and data.

I use the term "fluid" not in the sense of uncertainty or lack of substance but to describe an ever-changing panorama. Accounting science must keep, and has kept, pace with business and changing industry and commerce. What is correct today was not accceptable five years ago, and that, in turn, was not acceptable ten years earlier.

Accounting principles and practices have had to change as business has changed, as industrial organizations have changed, as the requirements of accounting data have changed, and as laws and administrative authorities have changed—as in the case of the tax laws and the Securities and Exchange Commission requirements.

The excess profits tax law focuses more attention on these problems and difficulties than any tax law we ever have had, because it involves a heavy tax on net income in excess of certain statutory credits or exemptions, both of which are historical in nature or, as in the case of Section 722 relief claims, fictional. A correct determination necessarily requires that the needed historical accounting and other factual data be available, or that the ultimate results which may now be reflected in the accounts presently appearing in the records of corporate taxpayers reflect the result of accumulated accounting in line with what is now required for tax purposes.

In seeking to develop a taxing statute which produces what seems to be the ideal result, legislators frequently fail to take into account, probably because the difficulties are not visualized, the inability of the taxpayer or his accountant to supply the answers required. So also do our jurists, who sometimes reach what may well be a

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practical result in a given situation, but in the process lay down a principle that is impractical in many other cases.

Greater leeway is available to administrative officials who, being less rigid in their approach, can recognize these difficulties and give credence to records, statements, or even working papers, notes or other records which, retained and presented in good faith, provide the only source for the development of data which is required by legalistic concepts and historical bases but which cannot otherwise be established by normal sources of evidence. We have yet to see whether or not that will be done, but as matters now stand it remains for the administrative officials to soften the impact of impractical legislative theory. Here are some of the specific problems we face:

Invested Capital Paid In

Congress has said that one of the norms for determining profits that are not excessive shall be specified percentages of capital originally paid in to taxpayer corporations, and, where the capital that was paid in took the form of property other than cash, it is to be measured by the cost of the property, which is usually its value at the date of acquisition.

Take a simple case and disregard such frills as "property at its basis for determining loss under the law applicable to the year in which it was disposed of" if it is no longer on hand. Such property may have been paid in twenty, fifty or more years ago. When such property consisted of what might be called consumable items, such as depreciable plant assets, inventory, etc., all of which have long since been consumed in operations, we might expect to have no problem, because whatever is treated as paid-in capital somehow or other becomes a charge against accumulated earnings or surplus, so that the one item of invested capital is reduced by the amount included in the other. However, that does not necessarily follow, because in dealing with the determination of accumulated earnings one is required to reduce profits actually realized by losses or deductions to the extent recognized for income tax purposes, and the so-called mitigation of the Statute of Limitations (Section 734) requires that there be an adjustment of the prior-year income tax liability if it was determined by treating any item entering into the determination of the invested capital in a manner inconsistent with the treatment accorded it in such determination.

Hence, in all such cases, it becomes necessary to ascertain when the consumable item was consumed and should have been treated as a deduction in determining taxable income (from 1913 on, only). If it has not been allowed as a deduction in the year in which it should have been allowed, the taxpayer may be in position to invoke the benefits of Section 734 to obtain an adjustment of the prior year's tax liability, or else force the Treasury to incorrectly determine the accumulated earnings for the current-year invested capital computation in order to be consistently incorrect with the prior treatment.

Thus a correct determination might require a complete revaluation as of the date of acquisition many years ago of plant assets, inventories, etc., as well as a determina-

tion of when they were consumed, even though they no longer exist and are not part of the capital with which the taxpayer corporation is now operating.

Similarly, when such permanent assets as goodwill are involved, a valuation, which may never have been made, may now be required. Furthermore, these problems apply not merely to the existing taxpayer but may apply to a series of predecessors, all of whom have long since expired but whose basis carries forward to the existing taxpayer.

Lucky is the taxpayer who has the records now available to even attempt to show its correct position. Valuations may have to be made "sight unseen" by persons who at the time had no idea of the existence of the assets they now are required to value, and will have to do that on the basis of cold, statistical data. And all too often those data are no longer available.

In the writer's own practice a number of situations have arisen in which such items as goodwill are required to be valued as of some early date and the records or other information of either the taxpayer or the predecessor are no longer available. A common method of evaluating goodwill is to predicate it on a capitalization of earnings for a period prior to acquisition. In many cases, particularly where the predecessor owner was a partnership or an individual proprietorship, records, if they were maintained at the time, cannot now be located. Sometimes old handwritten statements of net income written at the time are found at the bottom of musty old files. Such meager information attorneys may say is inadmissible evidence. In other cases the early earnings history of the present taxpayer, subsequent to the determinative date, must be used as the basis to which some yardstick of valuation must be applied to ascertain the extent to which such assets contribute to the invested capital currently in use. If a reasonable attitude in the acceptance of such data as are available is not adopted by administrative authorities, some taxpayers are going to suffer inequitable taxation.

Accumulated Earnings

Similar problems arise in connection with the determination of that portion of invested capital represented by what is described in the statute as the accumulated earnings and profits. No one as yet has attempted to define fully the term "accumulated earnings and profits," and even the statute goes no further than to indicate the treatment of certain items that enter into its determination. Where an accumulation of earnings exists, some of our problems disappear in the sense that one need not distinguish between the effect on capital and earnings of items that offset each other, as both constitute part of invested capital. Where a deficit exists, however, the problem becomes much more acute, for what enters into a deficit account is not considered in determining invested capital; but what affects paid-in capital is included in invested capital.

Base-Period Income

Some of the problems relating to the determination of invested capital, which is one of the measures of normal profits, have been described. Equally difficult problems have arisen in connection with the determination of the average base-period net income, which is the other measure of normal profits. Here the law permits or requires the adjustment of the income correctly reflected on tax returns for items recognized as abnormal, but taxpayers were not keeping their accounts in those days in anticipation of an excess profits tax law which would call for the adjustment of abnormal items. Accountants find, therefore, that some detailed analyses, theoretically required, cannot now be made with exactness.

As an illustration, consider the case of a taxpayer who suffered a strike during the base period. A strike usually involves the incurrence of abnormal expenses, possibly in the form of additional wages, the expenses of those who attempt to work, extra costs for trucking or transportation of workers and merchandise, losses through defective work or destruction of properties or merchandise, expenses of guards and compensation paid when work cannot be performed. All such items are usually abnormal in nature and, under the law, may be added back to the actual net income, determined after deducting such charges. Very often the costs have been absorbed through general expense charges including items that are not abnormal. The wages may appear in the wages account along with normal wages; merchandise losses may be absorbed in material costs of production; and lost, non-productive time may have been absorbed in either of those classifications or through overhead. How to extract the amounts representing the abnormal expenses or losses is often a problem and, when it is impossible to develop the amounts with exactness, we must resort to estimates or apportionments. Unless administrative authorities are prepared to accept such methods, some taxpayers will be denied justice in the determination of their tax liabilities.

Relief under Section 722

Finally, we come to what may be termed the fictional feature of our excess profits tax law, that is, the determination of relief from burdensome taxation and undue hardship which is available under the provisions of Section 722 of the Internal Revenue Code. Here the taxpayer must reconstruct and redetermine what its income would have been during the base period if the abnormal circumstances or conditions, specified in the law as entitling a taxpayer to relief, had not existed.

To use the statutory language, the benefits of this relief are available if "the taxpayer establishes what would be a fair and just amount representing normal earnings." The word "establish" is defined in standard dictionaries as: "to fix firmly," "prove legally," or with similarly strong synonyms. If that statutory language is taken literally, how will the taxpayer ever be able to "prove legally" results or earnings which, in fact, never materialized? Obviously, such a reconstruction of earnings must be largely a matter of estimate or opinion, or even guesswork. Unless adminis-

trative authorities approach these determinations with an open mind and with full recognition of the difficulties involved, fair results will not be obtained.

This publication will contain discussions dealing with principles of taxation in the development of tax laws or legal interpretations of what we have on our statute books. Ultimately, these technical matters will be settled by the enactment of tax legislation and the interpretation thereof by our courts. We shall be left with the problem of applying practically the resulting rules to the admissible data. The accountant can work only with what is in the records that are available to him. Unless both our courts and our administrative authorities deal with these difficulties as reasonable men—not seeking the last ounce of legal proof or evidence—no law will ever produce equitable taxation. It is heartening to note an expansion of this reasonable approach in both legislative and administrative policies. At the present writing, it must go much further, and it is the accountants' hope that as the wisdom and knowledge of the administrative organizations develop through greater experience in dealing with these problems, this tendency will continue.

PROBLEMS OF CORPORATE TAXATION IN TIME OF WAR

Roy Blough*

Five revenue acts in three years have transformed the federal taxation of corporate profits from an income tax taking approximately 17% of the $7.2 billion income of profitable corporations in 1939 to a combined income tax and excess profits tax which took approximately 56% of a $20.8 billion income of such corporations in 1942. It is expected to take 57% of an income of $23.4 billion in 1943. In the fiscal year 1940, corporation income and excess profits taxes constituted 21% of total Internal Revenue collections. In the fiscal year 1944, assuming continuation of present tax laws, corporation income and profits taxes are expected to yield about 35% of total Internal Revenue collections.[1]

These striking changes in the amount of corporation taxation might have been achieved by simple rate increases acting on a rapidly rising volume of corporate income. Actually, however, higher rates have been accompanied, and indeed overshadowed, by major changes in the methods of taxing corporations. A wartime system of taxing corporations, not merely a peacetime prewar system with higher rates, has been devised and placed in operation.

The changes in corporate tax structure were made because a satisfactory policy of taxing corporations in time of war involves not merely meeting the need for increased revenue, but also facing many other problems as well. Some of these problems were carried over from the prewar years, others have arisen primarily because of war, and still others relate to the period of postwar readjustment.

Tax problems are presented to Congress in very practical form. Congressional tax committees are denied the intellectual pleasure of theoretical study, of concentrating on some single objective, such as the equity of taxes, with no responsibility for, or necessary interest in, results of other kinds. Congress and its committees must act—and act with due regard for all the consequences. Their action takes the homely forms of specifying precisely what is to be taxed, at what rates the tax is to be imposed, and how and when it is to be collected. To do this they must balance

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[1] The tax figures are gross amounts. Post-war credits and the carrybacks of losses and unused excess-profits credits will reduce the final tax burdens substantially below these levels.

competing considerations and compromise conflicting interests; they must decide what results they desire to accomplish; they must achieve those results through altering an intricate legal and administrative machine that impinges on a complex economic organization. Congress must do its work in an atmosphere in which almost every taxpayer has a special interest to promote and in which a great many irrelevant issues must be examined and eliminated.

Acceptance of the winning of the war as the primary objective of tax policy is of some value in facing wartime tax problems, but by no means assures their solution. Many things are necessary to win the war and frequently they are alternatives—the more of one, the less of the other. Both ends of a seesaw cannot be up at the same time. It takes a fine sense of balance to get the most benefit from scarce resources. This balancing is notably difficult in war finance. To take two examples: Heavy taxation digs into tender flesh, economically speaking; light taxation leaves the door open to disrupting inflation. Again, high excess profits taxes may drain the vigor and efficiency of business enterprise; low excess profits taxes may lower the effort and morale of industrial workers, farmers and soldiers. What is the optimum point?

The changes under consideration here date from 1940. The 1940 and 1941 Acts were passed during the prewar period of "defense." The country had just emerged, perhaps was still emerging, from a long period of depression. The intellectual and emotional stigmata of the depression years were still evident. The climate of opinion changed substantially from 1940 to 1942 and 1943; the emphasis among different problems and aspects of problems shifted. For purposes of convenience, however, the whole period may be referred to as the "war period," except where greater precision appears necessary.

Problems Carried Over from the Prewar Period

Among the difficulties that Congress faced in constructing a corporate tax structure for the war were some of long standing which were underscored by the war. Of these chronic problems, two of the most puzzling are the measurement of business profits and the determination of the proper place of the corporate entity in taxation.

The measurement of business income

The taxation of any kind of business income, whether corporate, partnership, or proprietorship, presents perplexing questions. The statement of the amount of income or loss experienced by a business organization during any year must at best be an approximation; at worst it may bear no discernible relation to the facts as they are ultimately revealed. Business is a continuing process; to measure the income for the short segment of one year requires placing values on such things as buildings, equipment and inventories from which income is expected to flow in the future. The present value that is placed on expected future income reflects "the ectoplasm of a hope, not the solid granite of a fact."

This dignified guessing of the future is more difficult for long-range projects and projects in which capital rather than personal service is relatively the most important factor. These types of business ordinarily employ the corporate form.

Taxation of business income is difficult also because every variety of business has its own peculiarities of income determination. Measuring the annual incomes of a mine, a factory, a sales organization, a cattle ranch, and a motion picture studio involve widely differing complications. While some of these differences can be recognized in the tax law, the application of uniform rules to all kinds of business corporations is necessary for practicable administration. This very uniformity makes inaccuracy unavoidable.

Long-run accuracy in measurement of business income is assisted by allowances such as those for depreciation, depletion, and loss on retirement of machinery. Errors in allocating such allowances among years affect the amounts of taxes paid if losses occur in some years or if tax rates change. Prior to 1940 the principal statutory provision which made possible some adjustment for errors in calculation of the income of any year was the two-year loss carry-forward provision, which was restored to the law in 1939. This loss carry-forward provision did not, of course, apply only to those cases where a loss was due to the erroneous allocation of an item of income or loss in a given year or the erroneous valuation of an asset as of the beginning or end of the year. It also served to equalize somewhat the tax between corporations with violently fluctuating incomes and corporations with relatively stable incomes.

Tax problems inherent in the corporate form

A second difficult peacetime problem carried into the war period was the proper method of taxing corporations. Corporations are relatively easy to tax. They are all registered with state governments and cannot readily escape scrutiny. The great bulk of income and assets are in the hands of relatively few corporations; this means that auditing is facilitated.

Nevertheless, the business corporation presents perplexing questions of tax policy because of its characteristics as a form of business organization. The corporation is not simply a body of people who have joined themselves together to accomplish some common end. A large business corporation goes far beyond such simple cooperative group action. On the other hand, the corporation is not a completely independent entity, a sort of group person existing and functioning without regard to the natural persons who comprise it. The problem is to devise a method of taxation which will recognize the dual character of the corporation. A suitable technique might not be difficult to devise and apply if the relationships between the stockholders and the corporation were uniform throughout the corporate field. Actually, however, the relations of the stockholders to each other and to the corporations are of infinite variety, ranging from the close personal intimacy of the incorporated person or partnership to the impersonal relations of a large public corporation where no one stockholder owns more than a small minority of the voting

shares. There are large corporations and small corporations; growing corporations, stable corporations, and declining corporations; corporations with stocks closely held and corporations with stocks widely distributed; regulated corporations and unregulated corporations; corporations financed with bond issues, corporations with preferred stock issues, and corporations with neither; holding corporations and operating corporations; over-capitalized corporations and under-capitalized corporations; corporations with accumulated deficits and corporations with earned surpluses; corporations with harmonious stockholders and corporations with antagonistic minority interests; corporations run by management, corporations run by bankers, corporations run by a few large stockholders, corporations run by the mass of stockholders, and corporations that do not seem to be run by anyone. It is no wonder that a generally satisfactory method of taxing business corporations, either in peace or in war, remains yet to be imagined, let alone to be devised and adopted.

Although for constitutional reasons, the income tax on corporations[2] preceded the income tax on individuals, the corporation tax in the early years after 1913 may be considered in effect an adjunct to the individual tax. The original corporation tax rate of 1% was the same as the normal tax rate on individual income and dividends received by stockholders were not subject to the normal tax on individuals. Thus, with respect to the normal tax the corporation tax was analogous to collection at source. Dividends paid out of corporate capital funds or out of earnings before March 1, 1913 were not subject to normal tax or surtax in the hands of the receiving stockholders.

The first divergence between corporate and individual normal rates was in 1917, when the individual normal tax was imposed at two rates, and the corporation rate was made equal to the higher of the two, and an excess profits tax was imposed. The divergence continued after World War I. Beginning in 1919 the corporation income tax rate was lowered to 10%, but the maximum normal tax rate on individual income was still further reduced to 8%. The margin thus introduced between these two tax rates was widened when the 1921 Act raised the corporation rate to 12½% for 1922, to replace the revenue loss through the repeal of the excess profits tax. By 1929 the maximum normal tax rate on individual incomes had been reduced to 4%, while the corporation tax rate, at 11%, was nearly three times as high.

The corporation income tax could thus no longer be regarded merely as an advance or source collection of the normal individual income taxes.[3] On the other hand, the tax was still not a completely impersonal tax, since individuals were free from the normal tax on income from dividends. Congress presented no new principles of taxation in justification of the change in policy. Such explanations as were made usually ran in terms of the need for revenue.

[2] While to avoid constitutional obstacles, the federal corporation tax of 1909 was legally a franchise tax, it was measured by net income. Flint v. Stone Tracy Company, 220 U. S. 107 (1911).

[3] It was never precisely this, since the individual surtax did not apply, as it does in Great Britain, to dividends plus corporate tax.

In 1936 an attempt was made to integrate the corporation income tax with the individual income tax. The House of Representatives, following the recommendation of the President, passed a bill repealing the income tax on corporations and replacing it by a tax on undistributed profits. Under this bill distributed income would have been taxed only in the hands of individuals, while corporations would have been taxed only on undistributed income. However, the Senate was unwilling to accept without qualification this new approach to corporate tax problems. An undistributed profits tax was finally adopted. But the corporation income tax was retained and the rate graduated for corporate incomes of less than $40,000. In addition, individuals were no longer permitted to exclude dividends from income for normal tax purposes.

This compromise, which was incorporated in the 1936 Act, accentuated still further the issue of personal or impersonal taxation of corporation income. While the undistributed profits tax was an impersonal tax, its purpose and tendency was to bring income earned by corporations into the orbit of personal taxation; thus the corporation tax served as a supplement to the tax on individual income. But the denial of the dividend deduction to individuals was a move in the direction of impersonal taxation. The undistributed profits tax was vigorously criticized. In 1938 the rates were sharply cut and a date of expiration was set, and in 1939 the tax was allowed to lapse as of the end of the year. Only minor ties remained between corporation and individual taxes. They included an old penalty tax on income that is withheld from distribution in order to avoid individual income tax, a new (1937) tax on undistributed earnings of personal holding companies, and a provision (1939) for exemption from corporate tax of certain investment companies except with respect to undistributed income.

Aggravation of problems by the war

With the approach and outbreak of the war the difficulties involved in taxing corporations became more serious. The unsettled conditions brought about by the war, the conversion of plants and facilities to wartime production, the expectation that reconversion would one day be necessary, rapid changes in prices and costs, more difficult measurements of depreciation and obsolescense, the greater uncertainty of markets—all these factors combined to increase the difficulty of computing corporate profits in any year. There was even the question of accurately computing corporate profits for the war period as a whole. Apparently large wartime profits might be offset by the loss of capital value due to a shift of markets, the entry of competitors or the discovery of new technique and equipment. What appeared to be a profit in one year or even for the whole war period might turn out to be a loss, and what appeared to be a large profit might turn out to be a small one.

Not only were the dangers of making errors in the computation of income greater during the war than in the preceding time of peace but these errors became of increasing importance. If the rates of tax are low, errors in the calculation of profits from year to year are of relatively small significance. At a 10% rate of tax

it is rarely a matter of serious concern for the capital position of the corporation whether or not its profits are correctly computed. Even if twice as much profit is taxed as is actually realized the corporation still has 80% of its profits left to pay dividends and build up its capital. High tax rates, however, make a free and easy attitude toward the accuracy of profit computation a serious matter. If an excess-profits tax of 80% or 90% is imposed, and if by some mistake in calculation or in definition the profits are figured at twice their actual level, the tax may take not 80% or 90% of the profits but 160% or 180%. If such errors should continue over a period of time the business would go bankrupt. In any event there would be an actual loss after taxes instead of a profit.

Accordingly an important objective of wartime tax policy was to improve the calculation of profits or to make possible the hindsight adjustment in profits so that only actual profits would be subject to tax.

High rates of corporate tax also aggravated the discrimination against the corporation as a method of earning income to the extent that income was distributed in dividends. Low rates of tax on corporate profits would have discriminated in favor of the corporation to the extent that income was not distributed in dividends during the period of high war income tax rates. High corporate rates were particularly appropriate for those concerns whose incomes increased during the war since such increases were undoubtedly in general due to the war and the Government's war expenditures. For concerns whose profits had not increased, however, higher rates of taxation meant that the discrimination caused by the fact that the corporation was an intermediary between the individual stockholders and the source of income became more serious.

Problems Arising Primarily Out of the War

Added to the peacetime problems of corporate taxation, accentuated in time of war, were other problems attributable largely or solely to the war. The Government's revenue requirements were so much increased by the war as to constitute a difficulty almost of different kind instead of merely one of different degree. Profits growing out of war production presented a point of controversy. The overwhelming importance of unimpeded wartime production had to be reckoned with. Inflation threatened after a long stretch of years during which deflation had been the condition to be remedied.

There were other problems raised by the war which would be met after the war. These were truly wartime issues because they cast their shadows before them and affected the activities of both businessmen and Government in the consideration of war taxes. Another class of postwar questions may be anticipated during the war and provision made to go into effect after the war, but these are not truly wartime problems if nothing need actually be done during the war.

The distinction between a war tax problem and a wartime postwar problem may appear to be tenuous. Both arise out of the war; both call for consideration

during the war. The difference would appear to be this; if it affects production during the war, it is a war problem, but if it affects the postwar situation of industry, it is a postwar problem. An illustration may make this distinction clearer. The amortization legislation of 1940 was not intended primarily to protect industry in the postwar period and insure its equitable treatment then. The purpose of the legislation was to get on with war production which was allegedly being delayed by the unwillingness of business to make investments in wartime plants and equipment because of the uncertainty of getting back the investment. On the other hand, proposals for tax deductions for postwar reconversion reserves have been put forward, not so much to increase wartime production as to insure the existence after the war of the type of industrial machine and business control which is deemed desirable for that period, and to provide a correction for one source of error in statements of wartime profits.

The problems affecting conduct during war will be discussed in this section; the postwar problems seen growing out of the war and thereby affecting the war tax program will be discussed in the following section.

Additional revenue requirements

New revenue is an obvious wartime tax problem. As defense expenditures accelerated and then became war expenditures running up to unheard of levels, the need for greater revenue correspondingly expanded. Although some students of taxation are opposed to levying more than a nominal rate of tax on corporations, this view was not shared by the Congress. Members have pointed out from time to time that their constituents would not understand why the taxes on individuals should be increased unless the taxes on corporations were increased by at least a corresponding amount. Moreover, the ease of taxing corporate profits perhaps made inevitable the raising of a substantial portion of the newly raised revenue from the business corporations of the country. Finally, the strong influence of the high individual rates and other factors to discourage dividend payments during the war made higher corporate rates a necessity for tax equity, despite a resulting element of inequity.

Prevention and recapture of excessive profits

Although the need of revenue was responsible for substantial increases in corporation taxes during the war, the high corporation excess profits tax rates were not primarily the result of the need for revenue. The increased revenue could have been derived more simply and with less expenditure of time and energy by the Congress through higher income tax rates than by imposing the excess profits tax at such high rates that all sorts of relief provisions were required to prevent the heavy tax from causing hardships.

The primary reason for the excess profits tax was the public pressure for the limitation of wartime profits. Such pressure was not restricted to the United States. Both Great Britain and Canada imposed excess profits taxes early in the war at

very high rates. It was felt, at least in the democratic countries, that no one should make an inordinate profit out of a war in which conscripted men were risking their lives and in which many small businesses were being destroyed. There were wide differences as to what constituted unreasonable profits. Although unreasonable profits were obviously profits in excess of reasonable profits, the word "reasonable" added nothing to definiteness. Reasonable profits were interpreted by different people to mean everything from a sort of guarantee of peacetime profits after all taxes plus a generous percentage from the additional wartime business, down to almost no profits at all. But there was no difference of opinion on the point that, above some level, profits were undesirable in time of war and that insofar as practicable such excess profits should be completely wiped out.

This public attitude involved more than a matter of equity. It directly affected the production of goods necessary to the prosecution of the war, and the maintenance of stable economic conditions. The point was clear that income stabilization was needed. A policy of wage control developed; workers were expected to put forth their maximum efforts with stabilized wages and salaries. Price control likewise evolved; it was highly desirable that farmers raise maximum crops with stabilized farm prices. The cooperation in the war effort which could be expected of these groups whose incomes were limited would depend at least in part on what they saw happening to the incomes of other people who were not subject to the same types of restriction. These other incomes were primarily in the form of business profits—the profits of people who were employers of labor, some of whom were processors of farm products. The excess profits tax was the instrument adopted to restrict the incomes of this group. The success of the tax in securing the full cooperation of labor and farm groups would be one of the tests of its adequacy.

An important problem in the excess profits tax was the measurement of excessiveness and around this question was waged a vigorous fight. One view was that wartime profits were unreasonable when they were unusually high as compared to invested capital, regardless of how high they had been before the war. The other view was that profits were excessive when they were larger than before the war. The revenue acts of the First World War had incorporated taxes based on both of these tests of excessiveness. Whether or not both tests should be employed in the present war became an important issue.

There was no lack of discussion of war taxation in the decade prior to the war and almost all of it was devoted to the problem of preventing or recapturing excess profits in wartime. During the years between 1930 and 1940, numerous war finance bills and resolutions were discussed in both Houses of Congress. Some of them dealt with such questions as price fixing and profit limitation, or restriction. A large number of them were concerned with wartime taxation, and centered mainly around recommendations of the War Policy Commission[4] made in 1932, and rec-

[4] H. R. Doc. No. 264, 72d Cong., 1st Sess. (1932).

ommendations of the Special Committee on the Investigation of the Munitions Industry[5] made in 1935. The former proposed a flat rate tax of 95% on profits in excess of the average of the three preceding years. The latter committee recommended that profits in excess of 6% of the invested capital be taxed at a 100% rate. The discussion of excess profits taxation was thus important in Congress long before the excess profits tax was passed in 1940.

A profit recapture plan was placed in operation as early as 1934 with the passage of the Vinson-Trammel Act. This act provided for the recapture of all profits in excess of 10% of the contract price realized in the construction of naval vessels and aircraft. This type of provision was modified and extended in the years prior to the war.

Promotion of war production

Opposed to the considerations favoring heavy excess profits taxation were other considerations which raised a warning hand against rates so high as to weaken enterprise and destroy the incentive to efficiency. It may be doubted that the profit motive as such is of great importance in wartime. Few patriotic Americans would refuse to do their utmost in war endeavor, regardless of the size of profits. But it is not merely a matter of the size of profits; the question is also one of the loss of capital.

Although the Federal Government took many of the risks out of wartime business through its policy of furnishing capital, either in the form of facilities or in the form of loans, there was still a good deal of risk placed on private industry. The very size of the business in relation to the amount of private capital increased the risk of the loss of that capital through misjudgment or inadvertence. There was also a good deal of work and responsibility; and while this was no doubt offset to a considerable extent by the pleasures of management and the feeling of contribution to the war effort, there was nevertheless a general feeling that business profits must be not only reasonably low, but also reasonably high—high enough to reflect a reasonable return for the risk run and the managerial effort expended. Unfortunately, the ideas of what the entrepreneurial and managerial groups considered a reasonably high return, and what labor and farm groups and the public generally considered a reasonably low return, were not necessarily identical.

More definitely related to profit margins than is incentive to wartime effort is the incentive to efficiency of operation. Even in the absence of net profits after taxes, business managers and stockholders have an incentive to keep down costs during the war, since should the cost structure become inflated and distorted, the ability of the concern to compete in the postwar period would be impaired. This incentive is greatly strengthened by the provision for carry-back of losses and unused excess-profits credit, which provision makes even the profits that go to the Government in taxes valuable for purposes of future carry-back. However, there are offsetting

[5] SEN. REP. No. 944, Pt. II, 74th Cong., 1st Sess. (1935).

forces. High excess profits taxes, by reducing the net return on each dollar of output, make high costs less important. If paying higher wages will assure production and especially if those higher wages will be paid for by the Government in its higher contract prices, the tendency is strong to make the payments to labor and secure its good will during the war and perhaps for the postwar period. If advertising can be expected to yield results even at some future period, cost is a relatively minor factor if 80% is being paid by the Government through lower excess profits taxes. With regard to these and other elements of cost, high taxes on profits undoubtedly reduce the incentive to maintain business efficiency.

Various devices grew out of the effort to resolve the conflict between considerations for and considerations against a high excess-profits tax. Carry-forward and carry-back of unused excess-profits credit, the adjustment of the credit through "general relief," and the postwar credit were among these devices.

A special problem of promoting war production, which became acute in 1940, concerned the treatment for tax purposes of new plants and facilities constructed for the production of war goods. Manufacturers were reluctant to undertake these specialized capital investments without assurance that the loss of value during the war could be deducted from wartime profits. The problem involved a special application of deductions for depreciation and obsolescence. If wartime facilities were useless and worthless after the war, how was the manufacturer to get back his investment? The law provided then, as now, that depreciation might be taken as a deduction, as could obsolescence. Depreciation is based on physical life which might extend far beyond the end of the war. Obsolescence relates to economic loss of value, but is a difficult concept to apply administratively. It is hard to recognize obsolescence while it is occurring. It is sometimes difficult to determine that it has occurred and even more difficult to put a date on the occurrence. Obsolescence resembles loss in capital value due to shifts in demand, cyclically low production, and other more purely market factors in periods of business decline. Failure to distinguish obsolescence from these other factors would be of little significance to a correct statement of profits in the absence of business recovery. But business recovery causes capital appreciation in situations where obsolescence was not the cause of the earlier value decline. Truly obsolete equipment does not ordinarily appreciate when markets recover, since such equipment will have been replaced by technically superior and newer equipment. If all declines in capital are to be allowed as deductions from income then the restorations in capital value reflecting the restoration of markets should be counted as income. But taxing as income such accrued capital values not only outrages accounting traditions as to the nature of income, it also magnifies fluctuations of income and taxes and may lead to collecting taxes without regard to the business done and the profitability of operations.

Just how important were the uncertainties of charging depreciation and obsolescence against the income of the proper year is impossible to say. If the new plants were of such a character that they could continue to be useful after the war,

the amount of depreciation allowed under the Internal Revenue laws would be adequate as an income tax deduction. On the other hand, if the assets proved of little or no use after the war, either because the products would be useless in peacetime or because of an overabundance of such facilities in the postwar period or because of war inspired technological improvement, the usual deduction for depreciation would be inadequate to return the investment and reflect the true income earned during the war. The amount of difference this would make in taxes would depend on the rates of the tax and the income or loss position of the corporation in the postwar years. At any rate, businessmen insisted on special legislation to assure them that they would be able to take the cost of their wartime facilities as deductions during the war.

No exact solution was conceivable except a promise to recompute profits after the war, and promises were not definite enough. Measures that were definite were bound to result in inequities. Allowing deduction during the war of the full cost of the assets would understate the war profits of some concerns and thus undertax them. Failure to allow especially rapid deduction would, on the other hand, result in the overtaxing of other corporations. Advance determination of which situation would prevail could not be made for specific cases. Special amortization legislation was certain in any event to fall short of a fully satisfactory solution.

Control of inflation

Another important objective of war taxation is to contribute in maximum degree to the prevention and control of inflation. Because wartime inflation is due to an excess of spending power in a period of shortages of goods and services, the withdrawal of income through taxation is generally recognized to be an important instrument of inflation control. The circumstances which made the need for inflation control obvious in the latter half of 1943, were, however, not apparent in any great degree in the summer of 1940 when corporate tax revision for the war period was first undertaken. At that time the country was gradually emerging from a period of unemployment, low prices, and stagnant business. There was a substantial amount of room for growth in the output of the business machine without pressing on the capacity for production. Accordingly, the possible inflationary influence on prices of the increased governmental expenditures for defense purposes did not appear to be an important factor.

Even when productive capacity was approached and the strain of excess spending power on price controls became all too clear, the function of taxation as an instrument of inflation control was not given the acceptance or at any rate the emphasis which it received in some quarters. Several explanatory factors may be suggested. There are many problems on the minds of members of Congress, and little time for the complications of fiscal theory. The emphasis on price control and rationing indicates a preference for those methods of preventing inflation. Again, the legislator is close to the people back home. He sees each of them as a human being trying to improve his economic situation. Very few people are aware

that they are contributing to inflation. If their income rises, they feel that at long last they are receiving more nearly the reward which their labors had long since entitled them to. The cost of living, to be sure, threatens this newly found prosperity and security, but taxes would threaten them also. The average person apparently does not see increases in taxes as holding any benefit for him; rather he sees taxes as a reduction in his ability to buy, thus striking at the possibility of his reaping his overdue reward.

Even to the believer in taxation as a fundamental method of preventing and controlling inflation, the corporation does not appear as close to the inflationary picture as the individual. When corporations expand their facilities they spend money and thus contribute to the demand for goods and services on the market. But in the summer of 1940 there were few actual or threatened shortages of a character to give cause for immediate alarm. In 1941 and especially in 1942 and 1943 when shortages began to arise and finally became very critical, the system of priorities and the very existence of the shortages themselves reduced the ability of corporations to expand facilities for other than essential war purposes and indeed frequently prevented them from replacing deteriorating equipment or depleted inventories. Accordingly, money in the hands of corporations did not directly contribute in a large degree to the pressure on prices.

Of course, when corporations pay out their earnings in the form of dividends the pressure on prices is increased because of the larger incomes in the hands of the consuming public. Wartime dividend policies have been in general conservative because of high corporate and individual taxes, the costs of conversion to war production, the requirements of expanding war production, and the felt need for accumulating reserves and perhaps for other reasons.

In brief, the control of inflation was probably of little moment in 1940 and apparently had little, if any, influence on the revenue legislation of that year. In 1941 and 1942 the control of inflation had become of more importance for tax policy generally, but it was probably not an important factor in determining the increasingly high corporate tax rates.

WARTIME POSTWAR PROBLEMS

As the war progressed, more and more attention was given to the problems of the postwar period. What were businesses to do when the flow of war orders had ceased and the necessity to reconvert and readjust the plants and equipment to peacetime use became an immediate necessity? Wartime tax policy could not remove the problem. The best it could do would be to leave businesses in as favorable a position as possible to continue after the war consistent with a minimum of conflict with the wartime objectives of taxation.

Part of the trouble went back to the difficulty of measuring profits, especially in time of war. If, after the war was over, part of the wartime profits were found to have been apparent but not real, taxation might have impaired the capital of the company and left it worse off than it was before the war so far as capital was con-

cerned. This undesirable result was avoided to a considerable extent by providing a loss carry-back of two years. The loss carry-back method had the disadvantage that it made no distinction between wartime losses tied up so closely with wartime profits as to constitute a genuine adjustment of such profits, and ordinary business losses of the postwar competitive struggle.

The cost of postwar reconversion became a particular item of interest during the early part of 1943. It was felt by some observers that the loss carry-back provision was inadequate and that something additional should be allowed to free from taxation such amount of wartime income as would be used up in reconversion to peacetime operation. But the problem was peculiarly puzzling. During the war it was scarcely feasible to determine which companies would have to reconvert, or the probable costs of reconversion. Many corporations would never go back to their prewar line of business. Moreover, at the time of adjustment to peacetime conditions it was certain to prove difficult to ascertain which outlays should be chargeable as expense of reconversion, and which should be considered normal capital expansion to meet a new business situation.

The concern with the postwar conditions in which corporations would find themselves extended beyond the correction of wartime income to the cash position of the corporation. The cash problem is not at all the same problem as the problem of correctly figuring costs. A corporation with large assets and ample profits may be in a very illiquid position while another corporation may be very liquid and yet have made no profits. Although open or concealed rate reductions would affect the amount of cash a corporation would have at the end of the war, the problem of the cash position is largely in the field of business management and its relief is perhaps to be found in the banking and credit field. For concerns with war contracts, the policy of contract termination is also important for the postwar cash position.

There are other postwar problems, such as the future competitive situation among firms and industries, which are also sometimes presented as part of the wartime tax picture, but for the most part these seem rather far removed from the area in which wartime tax policy can be a helpful instrument.

The problems which Congress had faced during the past few years in determining wartime corporate tax policy are seen from this examination to be complex and confusing and full of conflicting considerations. No policy could have satisfied in full all the tests of good war finance. It has been necessary to balance considerations, to choose among conflicting interests. As the war passes into history it will appear more clearly whether the balancing has been intelligent and the choices best for the general welfare. But for Congress the end of the war will bring no rest from concern with corporate taxation matters. The wartime structure is obviously not suited to the postwar area; then the peacetime problems of corporate taxation will call for solutions adapted to new times and new conditions.

THE IMPACT AND BURDEN OF WARTIME CORPORATION TAXES

E. Gordon Keith* and E. Cary Brown†

I

The corporation tax structure as most recently revised in 1942 is yielding an unprecedented volume of revenue. Total tax liabilities of corporations in 1942 will be ten times as large as they were in 1939 (Table I), the major part of the increase coming from an excess profits tax which was not enacted until 1940. This tax alone accounts for almost $8 billion, or two thirds of total corporate tax liabilities in 1942.

But in spite of the huge increase in corporate taxes, it is estimated that income after taxes for all corporations will have increased from $4 billion in 1939 to over $7 billion in 1942. For profitable corporations, alone, income after taxes will have increased from $6 billion to over $8 billion. These increases in income after taxes are explained by the fact that corporate income before taxes rose from over $5 billion in 1939 to almost $19 billion in 1942.

A comparison of income after taxes in 1942 with 1941 of corporations in general shows an increase of 4%. However, Treasury estimates indicate that net income after taxes for profitable corporations, alone, will be less in 1942 than in 1941. The estimated increase of net income after taxes in 1942 over 1941 results from a decline in the estimated deficits of unprofitable corporations. Therefore, many individual corporations will have suffered diminutions in net income in 1942 as compared with 1941.[1]

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The opinions expressed are those of the authors, and do not necessarily reflect those of the Treasury Department.

[1] An examination was made of the earnings records of 373 large industrial corporations taken from the sample used by the Board of Governors of the Federal Reserve System in its series of quarterly earnings and dividends. A considerable number of these corporations reported substantially less income after taxes in the first three quarters of 1942 than the comparable period in 1941; income after taxes in 1942 of two-fifths of the sample fell more than 25 percent below 1941. Care should be taken in interpreting these data since they are based on *book* rather than *tax* data. Taxes were overaccrued to the extent they were based on the House version of the Revenue Bill of 1942 rather than the final act, passed in October. Furthermore, contingency reserves have been deducted. A sample of 40 large corporations exhibited an increase of 60 percent in reserve deductions in 1942 as compared with 1941; this increase represented 7 percent of 1941 net income.

TABLE I

NET INCOME AND TAX LIABILITIES OF CORPORATIONS, 1939-1942
(In millions)

	1939 actual	*1940 actual*	*1941 estimated*	*1942 estimated*
1. Net income, profitable corporations[a]	$7,232	$9,523	$15,950	$20,000
2. Deficits, unprofitable corporations[a]	1,977	2,226	1,700	1,000
3. Net income, all corporations[a]	5,256[b]	7,296[b]	14,250	19,000
4. Normal tax and surtax	1,216	2,144	3,750	3,900
5. Excess profits tax	—	375[c]	3,400	7,700[d]
6. Total taxes on income	1,216	2,519	7,150	11,600[d]
7. Net income after taxes, profitable corporations	6,016	7,004	8,800	8,400
8. Net income after taxes, all corporations	4,040	4,777	7,100	7,400

Sources: TREAS. DEP'T, STATISTICS OF INCOME, 1939-40, Pt. 2. Treas. Dep't, Div. of Research and Statistics, 1941-42.

[a] Excludes dividends received from domestic corporations, but includes tax-exempt interest.

[b] Due to rounding, individual items do not necessarily add to totals.

[c] Estimated.

[d] Net after postwar refund.

The impact of corporation taxes on particular corporations depends on the diverse situations in which they find themselves as a result of the war, as well as the particular taxes bearing on them in these situations, and their ability to pass on the burden of these taxes.

There are two general situations in which the impact of war taxation is especially heavy. First, increased normal and surtaxes bear heavily on corporations with stable or declining earnings before taxes during the war years. Corporations in this position, especially if they have outstanding preference shares, *e.g.*, public utilities, may find it difficult or impossible to maintain common-stock dividends at the prewar level, or even at reduced levels.

Secondly, the corporation with earnings greatly increased over their prewar level as the result of greatly expanded war production is inevitably subject to very high effective tax rates. These corporations often face cash shortages because of heavy working-capital demands and maturing tax liabilities.

In contrast, the burden of wartime taxation is much less severe for two other classes of corporations. First, corporations with high base-period earnings may earn a high rate of return before being subject to excess profits taxation. Secondly, corporations which customarily earn very low rates on large amounts of invested capital may substantially increase their earnings free of the excess profits tax. For example, with their large invested-capital credits, railroads have not been subject to high effective tax rates despite the tremendous increase in their earnings.

II

It is not only the impact in the first instance of wartime taxes on corporations which determines the relative merits or defects of the wartime corporate tax structure, but also their incidence and effects. Thus, it is necessary to consider how these taxes

are affecting the behavior of individual firms. Are they weakening the resistance to rising costs? Are they encouraging inefficiency, waste, and socially unnecessary expenditures? Are they retarding production? Finally, are they discriminating against stockholders by forcing upon them disproportionate reductions in current consumption?

Definitive answers to these questions cannot be given. Our experience with wartime taxation has been too brief to permit empirical tests of its effects on business practices and policies. In any event, the tax program is but one of many abnormal factors influencing the behavior of business firms in wartime.

The following is a preliminary appraisal of the burden of wartime taxes. In a situation in which the choices of businessmen with respect to the products they will produce and the prices they will charge are strictly limited by government controls, economic analysis operating within a peacetime frame of reference may have little relevance. Only within the framework of priorities, price and wage controls, and the role of the Government as the principal buyer, can the burden of wartime taxes be assessed.

1. Wartime taxes and costs

The excess profits tax may affect costs by affecting the efficiency with which labor and other resources are used in production, and the prices which businessmen are willing to pay for these resources.[2] It has been held that high excess profits taxes operate on both of these determinants of cost so as to impede the war effort. High marginal rates of taxation, it is argued, leave the businessman with little incentive to resist demands for increased wages and materials prices, or to exercise rigid controls over operations. Consequently, it is concluded, high tax rates lead inevitably to higher factor prices and increasing inefficiency in the utilization of labor and materials.

These considerations have important implications. Increases in wage rates, if they fail to increase the production of consumers' goods, tend to widen the inflationary gap between disposable income and consumable goods and services. Inefficient utilization of scarce resources either will have a similar effect, if the supply of consumers' goods currently available is reduced, or will decrease the output of war material. Thus, instead of being anti-inflationary, high excess profits taxes on corporations may contribute to the upward movement of prices. Although they reduce the opportunities for profit inflation, such taxes may well encourage cost inflation. Of these two forms of inflation, the latter may indeed be the more serious; a profit inflation may be more easily corrected in the postwar period than a cost inflation.

While high marginal rates of taxation may produce a situation favorable to rising costs, it does not follow that the present excess profits tax will necessarily raise prices by increasing costs. In the first place, the precise point at which taxes begin to weaken the profit motive appreciably is not rigidly fixed in the determinations of

[2] The effect of the corporation income tax on costs is probably not very significant, except to the extent that lower rates are anticipated after the war. This latter consideration may encourage expenditures which would not ordinarily be made at the present time.

businessmen. Secondly, the importance of the profit motive is reduced in time of war. Certainly, the decisions of businessmen in wartime are affected not only by high taxes but by other factors as well, some of which may offset or nullify the influence of the tax factor.

Effects on productive efficiency

The proposition that an 81% rate of taxation[3] on excess profits will encourage waste and inefficiency rests on two assumptions, neither of which can be accepted without qualification. One of these, namely, that business decisions are motivated primarily by short-run profit considerations, appears to be at variance with the admitted concern of most businessmen over their postwar operations. To allow inefficient and wasteful practices to spread throughout plants engaged in war production would be to weaken the postwar competitive position of such plants. If the short-run view is not the predominant one, a temporary tax, even if it were imposed at a 100% rate, would have less effect on business decisions than is commonly supposed.

The other assumption underlying the proposition that high war taxes encourage inefficient operations is that the performance of those persons who exercise direct control over business operations is determined in part by the level of profits after taxes. Especially in large enterprises, ownership and management are often not identical; the responsibility for efficient operations lies on management rather than on the owners. To the extent that the rewards to management are a function of the level of profits, the best measure of managerial efficiency is provided by profits before, rather than after, taxes. Moreover, management itself may be motivated by other considerations than the maximization of profits either before or after taxes. It may, for example, view efficient operation as an end in itself. Whether high taxes have an appreciable effect upon the quality of management, especially in the case of large enterprises is, therefore, open to question.

A stronger case can be made for the proposition that the excess profits tax may encourage expenditures which would not be made in its absence, if such expenditures are likely to yield benefits in the postwar period. The most obvious example of this kind of expenditure is advertising. A dollar spent for advertising in 1939 represented a net outlay of 81 cents. However, a dollar so spent in 1942 by a corporation subject to the excess profits tax represented a net outlay of only 19 cents.[4] A businessman who was in doubt whether an advertising dollar was worth 81 cents may be easily convinced that it is worth 19 cents. In other words, high taxes enable corporations to purchase valuable goodwill and prestige at little cost to themselves.[5]

[3] This assumes a nominal rate of 90%, less a postwar credit equal to 10% of the tax which may be used currently to the extent of certain reductions in debt.

[4] If the dollar had not been spent, the taxes on it would have been 19 cents in 1939 and 81 cents (taking into account the postwar credit) in 1942.

[5] The benefits from advertising must generally be yielded in a period in which lower tax rates are anticipated, otherwise the benefit would be taxable at the same rate as the cost is deducted. Even if rates are expected to remain high, however, additional advertising outlays may be encouraged.

Other examples of this kind of tax-stimulated spending can undoubtedly be found in higher salaries paid to executives, in larger fees paid for the professional services of lawyers, accountants, and tax consultants, more properly treated in the following section, and in increased outlays for maintenance and repairs.[6] In view of an existing excess profits tax, these expenditures can be justified by the firm in terms of probable future yields in excess of small current outlays.

These effects of excess profits taxes on efficiency and economy of production are offset by a number of other factors operating in time of war.

First, the Government is now the principal buyer of the nation's output. Although the Government's ability to maintain a careful check on the operation of those firms from which it buys should not be exaggerated, it is none the less true that cost analyses and controls are used by the Government in the placement of its contracts. Secondly, the Government can allocate scarce manpower and materials to the most efficient producers. Thirdly, salaries are subject to governmental control. Fourthly, the allowability of such costs as professional fees, advertising, and the like, as deductions for tax purposes is dependent upon their reasonableness as determined by the Bureau of Internal Revenue and the courts. Finally, in some future year or years the firm's earnings may fall below its excess profits credit, or losses may be suffered. The carry-back of losses and unused excess profits credits, authorized by the Revenue Act of 1942, may be sufficient to wipe out taxable excess profits completely. In this event the net cost of expenditures would be increased more than threefold, that is, from 19 cents per dollar of expenditure to 60 cents per dollar of expenditure.

In combination, these factors cannot be counted on to offset fully the influence of the tax factor on the efficiency of operations. However, they substantially limit its scope.

Effects on prices of labor and materials

Excess profits taxes tend to weaken the resistance of employers to demands for wage increases by reducing the net cost of these increases to the taxpayer. As in the case of expenditures for advertising, the taxpayer may bear no more than 19% of the wage increase. On the other hand, demands for wage increases would be strengthened by the absence of high taxes on excess profits as much as, or more than, resistance to these demands is weakened by the existence of such taxes. In any case, the Presidential order designed to stabilize wages has undoubtedly limited, for the present, unwarranted increases in wage rates.[7]

Another basis for the claim that the excess profits tax inflates costs has been found in the nature of government contracts. It has been declared that the procedure of renegotiating contract prices places all government contracts, whether fixed-price or cost-plus-fixed-fee, on a cost-plus-percentage-fee basis. The experience of the last war

[6] Under-maintenance characterizes the operations of many firms at the present time.

[7] Furthermore, had the decree to stabilize wages been politically possible without a high excess profits tax, wage costs, as distinct from wage rates, might have increased. Labor might not care to exert a maximum effort if this merely increased corporate profits.

demonstrated that cost-plus-percentage-fee contracts encourage inefficient production. In the present war, it is claimed, the amount of profits on contracts, as allowed by the various price adjustment boards, is determined as a certain percentage of total sales. Total sales may be a function of costs. Thus, allowable profits become a function of costs, encouraging cost increases. If a firm attempts to maintain profits after taxes at a constant level, it will, in the face of increased war taxation, inflate its costs and thus secure larger profits before taxes. So, it is concluded, a vicious spiral is initiated; higher tax rates result in higher costs.

In view of the cost controls previously discussed, the danger of cost increases arising from the nature of government contracts appears to be limited. Furthermore, the percentage of profit allowed by the price adjustment boards is not purely mechanical. Recognition is given to the efficiency of the firm and the trend of its costs, the more efficient firm being allowed wider profit margins.[8]

On balance, no conclusive statement can at present be made regarding the effect of the excess profits tax upon costs. However, the increases in costs which might ordinarily result from an excess profits tax must run the gauntlet of many wartime controls, and are, thereby, undoubtedly minimized.

2. *Wartime taxes and prices*

In addition to the indirect effects which wartime corporate taxes may have upon prices *via* costs, such taxes may enter directly into the determination of price policies.

In peacetime the framework within which the firm must formulate its price policy is established by the competition both of other firms within the same industry and of other industries. The price policy of a given firm is conditioned by the price policy of its competitors, and intelligent decisions to alter prices must take into account possible repercussions upon the decisions of competitors. Moreover, the sole aim of the firm's price policy cannot be to maximize profits in the immediate future. Too high a level of profits might invite governmental regulation or new competitors to enter the industry, thus prejudicing long-run profits.

Businessmen usually insist that within this framework it is possible to shift higher income taxes onto consumers, while, until recently, economists generally have held this not to be the case.[9] These issues cannot be resolved here. It may be useful, however, to point out some of the changes wrought by the war in the framework within which price policies are formulated.

One important change is the new role of the Government as the ultimate purchaser of over half of the current output of goods and services; its control over

[8] Joint Statement by the War, Navy and Treasury Departments and the Maritime Commission, *Purposes, Principles, Policies and Interpretations under Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, as amended,* March 31, 1943.

[9] See E. R. A. Seligman, *Income Taxes and the Price Level,* in STUDIES IN PUBLIC FINANCE (1925); and W. H. Coates, *Memorandum on the Incidence of the Income Tax,* APPENDICES TO THE REPORT OF THE [COLWYN] COMMITTEE ON NATIONAL DEBT AND TAXATION (1927) App. XI. However, for a different viewpoint, see D. H. Robertson, *The Colwyn Committee, the Income Tax and the Price Level* (Dec. 1927) Vol. 37, No. 148, ECON. J., p. 566 (reprinted in ECONOMIC FRAGMENTS); DUNCAN BLACK, THE INCIDENCE OF THE INCOME TAX (1939).

the price policies of firms is increased. There is, nevertheless, a wide range of indeterminancy in the formulation of reasonable prices, within which contracting officers and price adjustment boards might allow for wartime taxes through higher contract prices.

Although contracting officers, knowing that most excessive profits will be recaptured by wartime taxes, may not haggle as long over prices as they otherwise would, the placement of orders on an individual-contract basis makes it unlikely that contracting officers could, or would, make direct allowance for wartime taxes. Furthermore, the process of renegotiation by the price adjustment boards makes available to the military establishment a further check on contract prices. The general position of these boards is reflected in the statement "that the reasonableness of profits should be determined before provision for Federal income and excess profits taxes."[10]

Aside from its regulation of war material prices, the Government, in wartime, controls the prices of consumers' goods and services. With purchasing power greatly exceeding the flow of goods available for purchase, the possibility of a price policy which transfers the burden of wartime corporate taxes to the consumer would seem greatly enhanced. However, the Office of Price Administration, the agency under whose jurisdiction has been placed the pricing of most consumers' goods and services, holds:[11]

> For price control purposes it is profits before taxes that are significant. The Congress determines, in its tax legislation, what shall be the distribution of the financial burdens of war —who shall pay the taxes and how much they shall pay. To permit prices to increase so as to cover income and excess profits taxes levied upon corporations, and thus to permit such taxes to be passed on by the corporation to the consumer, would defeat the intention of Congress.

A similar policy has been followed in the regulation of transportation and public utilities.[12]

This does not mean that wartime taxes may not indirectly affect prices. Because of the reduction in corporate income after taxes resulting from wartime taxation, the amount of reasonable profits before taxes allowed by public agencies may be more generous than would otherwise be the case. Indeed, the Office of Price Administration has stated: "So necessary was the expansion of output to our defense in the period prior to December 7, 1941, and to the successful prosecution of the war since that date, that the Office felt impelled to err in the direction of laxity rather than in

[10] Joint Statement, *op. cit., supra* note 8, at 7.

[11] OPA, THIRD QUARTERLY REPORT (for the period ended Oct. 31, 1942) 23.

[12] In the determination of public-utility rates, only peacetime taxes have been allowed as a cost. The Federal Power Commission has stated: "Increased tax burdens must be borne by the utility which enjoys a monopolistic position in the economic field, as well as by others who have no such advantage." Fed. Power Comm'n, Op. No. 80, In the Matter of Pan Handle Eastern Pipe Line Co. and others, Sept. 22, 1942, p. 31.

Transportation-rate determination by the Interstate Commerce Commission has generally not taken income taxes into account. Reduced Rates, 68 I.C.C. 767, 683 (1922) cited in Increased Railway Rates, Fares, and Charges, 248 I.C.C. 556 (1942).

the direction of rigor."[13] In the absence of wartime taxation, such laxity would probably not have been permitted.

This examination suggests that the price level is somewhat higher than it would have been in the absence of wartime corporation taxes. However, to the extent that the Government is itself the purchaser of goods and services, the net price paid (actual expenditures less tax receipts resulting therefrom) is the price which must be taken into account. As substantially less than 100% of wartime taxes are included in the prices actually paid, it follows that this net price must be less than it would have been in the absence of such taxes.

The same conclusion, however, cannot be extended to the prices of goods and services purchased by individual consumers. Increases in prices of consumers' goods will impose varying burdens on different income groups.

3. Wartime taxes and dividends

An appraisal of wartime taxation must also consider the effect of such taxation on the payment of dividends by corporations. This effect is of particular importance in assessing the burden of wartime corporation taxes on the individual owners of corporate enterprise, since, in some cases, dividend income represents their only current claim on the national product.

Furthermore, as consumable commodities become increasingly scarce and as prices rise, firms may strip themselves of working capital in order to meet increased demands for dividends by stockholders. Such a reduction of working capital would have serious postwar implications by increasing the difficulty of the postwar readjustment. On the other hand, failure of wartime taxation to siphon off possible increases in dividends as a result of increased profits would only increase the present gap between commodities and services available for consumption and disposable income.

The relationship between dividends paid[14] and corporate net income after taxes[15] for the period 1933 through 1942 as shown in Chart I below, does not include the years 1936-37 and 1942. The undistributed profits tax was in effect in the first two of these years, resulting in larger dividend payments than would otherwise have been the case. The line of regression (Chart I) indicates that for the period from 1933 through 1941, a change of 27 cents in dividend payments was associated with a change of one dollar in net income.[16] In the year 1942, however, although net income after taxes *increased*, dividend payments *decreased*. If the same relationship between net income and dividends in the period 1933 through 1941 had been maintained in 1942, dividends would have been $4,650 million, rather than $4,200 million.[17] To what can this seeming change in behavior be attributed?

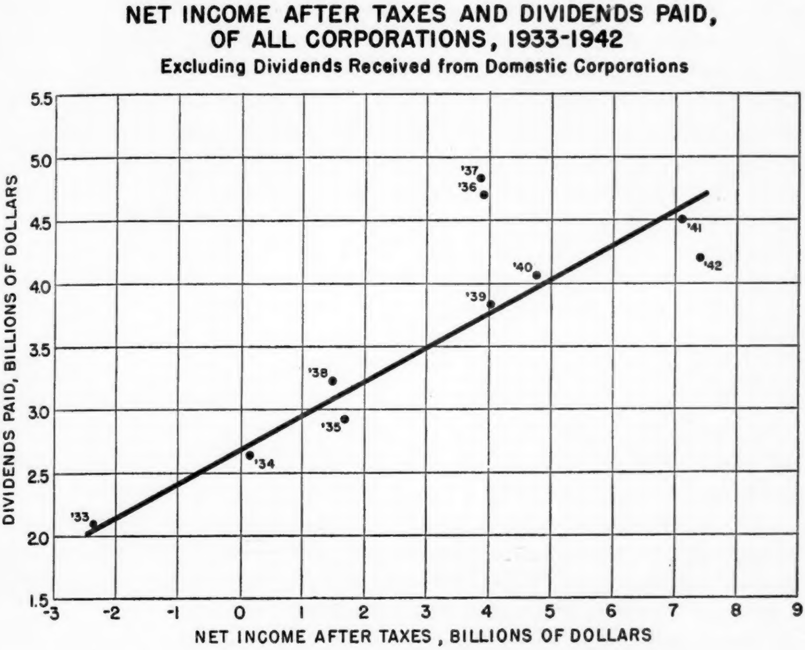
[13] OPA, *op. cit.*, *supra* note 11, at 26.

[14] Gross dividends paid, less dividends received from domestic corporations.

[15] Compiled net profit or net loss, less all taxes and dividends received from domestic corporations.

[16] The line of regression was $Y = .27X + 2679$ million; the coefficient of correlation was .99, and the standard error of estimate, $117 million.

[17] A recent estimate by the Department of Commerce is even lower—$3,983 million. See Tynan Smith and Robert Sherman, *Recent Trends in Corporate Profits*, SURVEY OF CURRENT BUSINESS, June, 1943.



Source: For 1933-'40, U.S. Treasury Department, Statistics of Income, Part 2. For 1941-'42, U.S. Treasury Department, Division of Research and Statistics.

In the first place, the proportion of the 1942 excess profits tax liabilities represented by the postwar credit (10%) has not been deducted from net income after taxes. For current dividend purposes, however, the postwar credit represents a commitment of funds in the same sense as taxes,[18] unless used for debt repayment. It may be as large as $500 million. If 1942 income were reduced by this amount, the relationship between income and dividends in that year would diverge less from the 1933-41 relationship.

Furthermore, it must be recalled that the increase in corporate net income after taxes in 1942 over 1941 is not attributed to an anticipated increase in aggregate net income of income corporations, but to a decrease in aggregate deficits of deficit corporations.[19] This factor alone would have reduced aggregate dividends as compared with aggregate income. That dividends were not more greatly reduced may imply a weakening in the working capital position of some net income corporations, particularly when the postwar credit discussed above is taken into account.

This latter point may take on further significance when the inadequacy of an annual determination of income is considered. Income may be overstated because

[18] Strictly speaking, this may not be true. Increases in the postwar credit may result in reductions in the amount of government bonds or similar securities which would otherwise be held by the corporation.

[19] See Table I, *supra*, p. 122.

of inventory profits, undermaintenance of assets, inadequate provision for depreciation, or failure to reflect currently a reduction in income owing to possible future losses. On the other hand, amortization of emergency facilities understates profits. On balance, taxable income may be overstated. If corporation management bases its dividend policy on such overstated income, the corporation may find itself with inadequate postwar reserves.

Finally, in a period of rapid expansion of output, as in 1942, cash demands for new facilities, additional inventories, and working capital, may require extensive plowing-in of profits. As long as taxes take a relatively small percentage of net income before taxes, dividends may be maintained in spite of this expansion. However, if taxes take a substantial portion of net income, expansion may be possible only at the expense of current dividends.

All of these considerations must be weighed in assessing the presence or absence of conservatism in corporate dividend policies in 1942. As yet, it would appear that corporate dividend policies, taken as a whole, have fully taken into account the wartime corporate tax program, and have reduced dividends concomitantly.[20]

4. Wartime taxes and production

The general relationship between war taxes and the level of production has been discussed above,[21] where particular attention was given to the effects of high marginal rates of taxation on productive efficiency. The excess profits tax may also affect the level of war output in a number of special situations.

The excess profits tax affects the availability of investment funds needed to finance increased production. This tax, generally speaking, makes no allowance for risks assumed in expanding war production. The firm which, at the behest of the Government, undertakes to double, triple, or quadruple, its normal output is allowed, in addition to its average-earnings base, only 8% of its net equity capital additions through sale of stock. This in effect usually means that the more war production is expanded, the more closely the excess profits credit approaches the 8% return allowed on additional capital.[22] Although an assured return of 8% for the postwar as well as the war years might be sufficient to attract new equity capital into these expanding enterprises, the high degree of uncertainty with respect to the postwar position of these firms makes them relatively unattractive outlets for investment funds. Consequently, the high effective rates of taxation to which many such firms are subjected not only prevent them from financing their working capital needs out of profits, but also serve to deprive them of new working capital from private sources.[23] This

[20] Many corporations, as evidenced by their 1942 financial statements, are substantially discounting current earnings by setting up contingency reserves. These reserves are not deductible from taxable income.

[21] See p. 124, *supra*.

[22] Corporations with invested capital of less than $5 million may find it to their advantage to use the invested-capital method of computing the excess profits credit which allows such corporations a credit of 8% on old and 10% on new equity capital.

[23] To the extent that the requirements for increased production take the form of new plants and equipment, recovery of the investment in such plant is facilitated by the five-year amortization provisions enacted in the Second Revenue Act of 1940. These provisions, however, do not extend to working capital, and it is largely with respect to this type of capital that the small firms face particular embarrassment.

financial problem is especially critical in the case of small firms with low excess profits credits.

Thus, growing firms are confronted with the alternative of expanding operations less rapidly than is desired by the Government, or of obtaining funds from Government sources. Through its various agencies, the Government does stand ready to finance both the fixed-capital and working-capital requirements of firms engaged in filling war contracts. The Reconstruction Finance Corporation makes direct loans to such firms on the security of the contracts. In addition, the military establishment makes advances on war contracts, and subcontracts. The military establishment may also guarantee loans made by banks and other lending institutions to war contractors —the so-called "V-Loan."

It appears, however, that government assistance in financing working-capital requirements has not altogether overcome the financial difficulties of small expanding corporations. Complaints are still made that the high effective rates of taxation to which these firms are subject are interfering with the potential expansion of the war-production program. Consequently, it can be said that the financial difficulties attributable in part to high war taxes threaten at some points to prevent the attainment of maximum output.[24]

The tax law does make allowances for unusual risks associated with attempts to increase the production of much-needed war materials under certain special circumstances. In order to encourage the production of the so-called "strategic minerals," complete exemption from excess profits taxes has been given to profits from the production of twelve minerals, most of them not ordinarily produced in the United States.[25]

Another special case in which excess profits taxes may inhibit production if excess profits are inaccurately defined is to be found in the case of certain mining properties.[26] The amount of income which most operators can ultimately derive from such properties is limited by the extent of ore reserves. Whereas the acceleration of production during the war years need have no effect upon postwar operations of nonmining enterprises, the greater the increase in mine output during the war, the smaller will be the potential output in postwar years. Therefore, if the acceleration of output subjects mining operators to excess profits taxation, they may have an inducement to limit output during the war.

However, the acceleration of output need not always mean that the owners of mineral resources will be unreasonably burdened by heavy taxes on income bunched in the war years. The severity of the hardships imposed will, in general, depend upon the extent to which accelerated output during the war will actually reduce postwar profits. If the additional output is small relative to the total reserves in the property,

[24] This conclusion is based on views expressed by small businessmen engaged in production under war contracts.

[25] Revenue Act of 1942, §226.

[26] A similar situation is found in the case of timber properties, although for certain types of timber stands more or less continuous operations are possible.

no great sacrifice is imposed on the operator who is forced to accept a low profit margin on ore which would not have been mined for at least 20 or 30 years. Even if a profit at the end of that time was assured, its present value would be small. Moreover, the extraordinary demand for certain minerals during the war may afford some owners of mineral resources an opportunity to recover assets which they would have little or no chance to recover under normal circumstances. Many marginal ore deposits are now being worked which will have little value to their owners once foreign sources of supply are again opened up.

This special situation of the operators of certain mining and timber properties was recognized in the Revenue Act of 1942,[27] and relief from excess profits taxes was afforded to such operators with respect to income attributable to accelerated output. Operators are, however, given full relief from excess profits taxes on income attributable to their increased output only in those cases where such output represents a high percentage of remaining reserves.

III

The conclusions of this analysis can be summarized briefly. In the first place, the excess profits tax in wartime has certain limited effects on the cost of production. Similar effects do not result from the corporation income tax. In the second place, wartime corporation taxes exercise some direct influence on the price level; they tend to relax, somewhat, the severity with which prices are regulated. This price effect is in addition to that resulting from increased costs. In the third place, wartime corporation taxes have held 1942 dividends as compared with net income after taxes at least to the average relationship between income and dividends from the years 1933 through 1941. In general, the financial strength of corporations does not appear to have been impaired. And finally, excess profits taxes, in some cases, have increased the financial problems of some firms and thus prevented the full attainment of potential output.

[27] §209.

AN APPRAISAL OF THE EXCESS PROFITS TAX FROM A FISCAL STANDPOINT

Harold M. Groves*

Certain institutions though irreproachable as to ends are discredited by clumsy means; they are right and valid by definition but the definition will not stand the test of application. The excess profits tax belongs to this order.

We are committed for the war period to a program of high business taxation with much stress on the excess profits tax. It may be in order, nevertheless, to appraise the excess profits tax in the light of new experience. The degree of the tax, at least, is a matter for further consideration, and the question of what disposition to make of this emergency levy when peace is resumed is timely. To treat the latter issue satisfactorily it is necessary to raise anew the question of the proper place of business taxation and to weigh the excess profits tax against alternative sources of revenue.

I. The Excess Profits Tax as a War Measure

The profits tax, as a war measure, stems from some sound roots in the soils of expediency and principle. It is not a matter of chance that this tax appeared in the war finance programs of most of the belligerent countries in the First World War and that it has been generally reintroduced during the present struggle.[1]

During both emergencies the excess profits tax has proved a mainstay of revenue yields for the United States. The excess profits tax of 1917 was described by Professor Robert Murray Haig[2] as "probably as deservedly unpopular as any tax measure could well be," and the later measures of the First World War left much to be desired. But these taxes brought money rolling into the Treasury, and they are now described as "the most important single source of tax revenue" during the war period. The record is still being made in the case of the present war, but it is already apparent that the excess profits tax will play a leading role as a revenue producer.

This war has set a high watermark for governmental control of the so-called private economy in the United States. Much of this control has taken the form of freezing pre-war economic relationships, including the prices of finished products, raw materials, and labor. The profits tax with its 90% rate and its emphasis upon

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[1] See Buehler, *The Taxation of Corporate Excess Profits in Peace and War Times* (1940) 7 Law & Contemp. Prob. 291.

[2] Haig, *The Revenue Act of 1918* (1919) 34 Pol. Sci. Q. 382.

pre-war experience of each individual company, aims at a near-freeze in the area of profits, not very different from that which is applied elsewhere in the economy.

An excess profits tax program, during this war, was nothing short of a political necessity. It was required to satisfy the demand of those who were involved at other points in the freezing process. It was an answer to those who sought insurance that none would profit from the nation's misfortune. It was demanded as a monetary counterpart to the sacrifice being made by persons who entered the armed forces. And it was a very plausible response to the feeling that the state has an equity in the profits created by its own extraordinary outlay.

The competitive checks upon excessive earnings normally operative (though not too perfectly) in times of peace are largely suspended during a war. This is due to the extraordinary rapidity of events and the extreme urgency of much of the demand. The Government becomes the sole buyer for many producers and in the sellers' market prevailing they can (except for the political controls) largely name their own prices.

If there are valid grounds of support for the excess profits tax in wartime, there are also many objections to it. One of the strongest is the legitimate doubt as to the sufficiency of the incentives remaining after the imposition of a very severe tax. The incentives to conserve and to risk and to produce at a maximum are hardly less and probably more important during war than normally. But a powerful new incentive is now available as a partial substitute for the profit motive. This is the patriotic incentive. It has elements of self-interest as well as of altruism. The former were stressed by Secretary Morgenthau when he stated before the Ways and Means Committee[3]: "There can be no fair quarrel with the imposition upon corporations of a substantial proportion of the increased load of taxation required by our national peril. We are fighting for the very system of free enterprise which makes corporate profits possible." Businessmen have frequently expressed the conviction that they are not interested in abnormal profits during the war; that they intend to do their best for the war effort, profit or no profit. It would be naïve, no doubt, to conclude that this attitude is universal, but it must be conceded that patriotism is an excellent lubricant for any tax mechanism in wartime.

Patriotism may be a good substitute for the incentives of free enterprise, but it cannot be as effective as a combination of patriotism and strong economic incentives. Some British critics have expressed the view[4] that "the economic incentives can be safely cut down to some extent (in war time) though it can not be cut down by more than a limited amount without dangerous consequences." This view is supported with the observation that "an excess profits tax is especially likely to fall upon the margin, where it will do most damage"[5] and "the opportunities for abuse and evasion inherent in an excessively high excess profits tax are enhanced by the fact that it is a temporary tax."[6] They add that under these conditions "anything which

[3] Statement of Secretary of Treasury Henry Morgenthau, *Hearings before the House Committee on Ways and Means, Revenue Revision of 1942*, 77th Cong., 2d Sess. (1942) vol. I, p. 6.

[4] J. R. HICKS, U. K. HICKS, & ROSTAS, THE TAXATION OF WAR WEALTH (1941) 44.

[5] *Id.* at 43.

[6] *Id.* at 45.

is done in the interests of future profits stands a good chance of evading the tax."[7] And it is concluded that "a 100 per cent tax, such as was imposed by the Italians in a weak moment in 1919, and such as is now in force in Great Britain, is beyond all question very dangerous indeed."[8]

The quite substantial increase in advertising, despite the public interest in reduced consumption, both during the last war and this, can be cited in support of the fears expressed above. Much of this advertising is of the "goodwill" variety designed to enhance markets and hence profits after the war. This is done mainly at the expense of the Government (via reduced taxes) during the war. Probably advertising could be rationed. Also the Treasury might tighten its rules under which advertising outlays are deductible for tax purposes, but this would not be an easy solution from an administrative standpoint.

The nominal rate of 90% in the present federal law is somewhat softened by the overall limitation on federal corporate taxes (normal, surtax, and excess profits tax) at 80% of net income, and by the provision for a post-war credit to the extent of 10% of the excess profits tax.[9] The exact degree to which an excess profits tax can be pushed without seriously undermining incentives is not determinable. The matter was carefully deliberated by the Treasury at the time the present excess profits tax rate was adopted, and, although Congress went considerably beyond the Treasury's recommendation in the rate finally chosen, the present levy may still be within the range of safety. It seems likely that the elasticity in this direction has at all events been exhausted.

The net effect of war profits taxation upon inflation is a question filled with complications and of doubtful answer. The problem offers at least four approaches. The first might be termed the pressure-on-prices approach. Insofar as producers can raise prices of their own volition, they may be discouraged by the excess profits tax, which requires in effect that price increases must be shared with the Government. On the other hand it may be argued that the excess profits tax has the exactly opposite effect, for producers will raise prices all the more in order to compensate for the levy. A second and probably more useful approach looks to the effect of the excess profits tax on purchasing power. Directly, the tax may cause a reduction of dividends, some of which would be destined for spending. But there are also indirect effects on purchasing power. The tax may lead to an "easy wage policy," that is, to reduced resistance to wage increases because of the producers' reduced stake in their marginal dollars. Here again the opposite can be argued but not very convincingly; that is, it can be contended that the tax increases wage resistance because it cuts down the surplus out of which such increases might be granted. The third approach is from the effect-on-cost angle. Does the tax lead to waste and carelessness, and are there loopholes like that for advertising expense which will be used to inflate costs and eventually prices? Finally, there is the political approach which considers the argument that heavy excess profits taxes are a condition precedent to asking labor to

[7] *Ibid.* [8] *Id.* at 44.

[9] The Act allows the credit to be taken currently to the extent of 4% of the net debt repayments by the corporation during the taxable year.

"take" wage controls and farmers to "take" price controls. Even this rather elaborate analysis does not exhaust the possibilities. Probably it is safe to conclude that the profits tax is not an effective check on inflation but that its net effect is at least not harmful.

Only a little less complicated and uncertain is the question of incidence of the excess profits tax. It is quite possible that government contracts, a very important element in industrial profits in wartime, are liberalized because of anticipated profits taxes. To the extent that this be true, these taxes involve only a circular movement of money out of and back to the Federal Treasury. They also fail in their objective of preventing unjust enrichment. The failure of quite heavy excess profits taxes to prevent much war-caused enrichment during the last war and the persistence of large net profits after taxes in this war lend plausibility to the theory. However, the plausibility decreases as the tax rate mounts. Obviously, if the rate were 100%, any allowance for profits taxes in the terms of contracts would be futile. The much disputed renegotiation of contracts was based substantially on the thought that the incidence of an excess profits tax at less than confiscatory rates may be on the Government and may thus be ineffective in preventing excess profits. It has also been contended frequently[10] that the incidence of the excess profits tax is partly on the consumer. Professor Seligman doubted the validity of this contention on the ground that there were probably untaxed marginal concerns even in wartime.[11] Probably the strategic factors, such as the fact that price-determining forces operate in a sellers' market, are far more important than any considerations of marginality. The issue may seem to be of academic interest on the ground that the price-freezing program now probably prevents any important shifting to the consumer. Nevertheless there is no general agreement that the price controls are that effective.

It is quite well agreed that the weakest point in the armor of the excess profits tax is the technical difficulties of its application. No sensible person can be very enthusiastic about a tax measure which makes the ultimate rewards of the economic process mostly a matter of luck or of political (as contrasted with economic) efficiency. This is the danger that lurks in the technical difficulties of the excess profits tax. Undoubtedly the techniques of applying the tax have greatly improved since we last experimented with this form of taxation 25 years ago. But the arbitrariness and the anomalies are still very conspicuous. To choose a few more or less at random: Why should the concern that operates on borrowed capital have the privilege of including half of such capital in the tax base (for calculating the return on invested capital), whereas a firm which rents its capital has no such privilege? Why allow a personal service corporation to escape the excess profits tax on the ground that its income is mostly from services rather than capital, when many other corporations show the same characteristic but only to a lesser degree? Why tax a developing corporation on the theory that its success must be due to the war, while a declining corporation, which may have received a real lift because of the war, escapes? These matters are

[10] Seidman, *Influence of Excess Profits Taxation on Business Policy* in FINANCING THE WAR (Tax Institute, 1942) 51.

[11] SELIGMAN, ESSAYS IN TAXATION (10th ed. 1925) 706.

of course in addition to the standard complaint that no attention is given to varying degrees of risk. Relief provisions, the carry-over and carry-back of unused excess profits credit, and other refinements have helped make the present tax less arbitrary than those employed during the last war, but the staunchest friend of the tax would not claim that the technical problems of application are anywhere near solution.

Anyone who takes the pains to study the multitudinous points of subtle distinction and classification[12] involved in an excess profits tax cannot fail to appreciate the very great possibilities for injustice and unfair competition that are involved in its application. An exceedingly complicated law is essential to cover the many conditions to which it must apply and much has to be left, even then, to administrative procedure. The historical approach to the definition of capital is probably the best that could be devised, but it involves resurrecting and some recasting of a multitude of records which have been regarded as buried. In this connection it may be recalled that when the excess profits tax came before Congress in the early years of the present war, there were cases still pending in the courts dealing with the determination of invested capital under the 1918 law.[13] Moreover, accounting is not an exact science, and it is hard put to give the precise answers required by a 90% excess profits tax. Confronted with the prospects of unjust application in many instances, the lawmakers very generously gave the taxpayers a choice of alternatives—the invested-capital and the previous-earnings methods of calculating excess profits. But it is apparent that this combination of generosity and stringency will often not average out to a salutary result.

II. EXCESS PROFITS TAX IN THE TRANSITION PERIOD AND IN PEACETIME

The excess profits tax is set up as an emergency measure and in such manner as to indicate the absence of an intent to carry it beyond the war and perhaps the interlude between war and peace. Even before the war is won, near-certainty of victory may weaken considerably the patriotic motive which helps sustain a very high rate of tax. A further trend in this direction during the post-war interlude should justify a downward revision of rates.

As we pass from conditions of war to those of peace, there will undoubtedly be a demand as there was in the 'twenties for a retention of the excess profits tax in the peacetime tax system. It is not too early to give some thought to whether we should accede to this demand. Most of the valid grounds for an excess profits tax in time of war disappear in time of peace, and most of the limitations of this form of taxation are accentuated. Most important of all is the fact that we have no conceptual basis for an excess profits tax in normal times.[14] Most plausible of the suggested bases is that excess profitability results from monopolistic production and that we should try to measure and recapture the monopoly gains. There has been considerable sup-

[12] Shoup, *The Taxation of Excess Profits* (1940) 55 POL. SCI. Q. 535, (1941) 56 *id.* 84, 226; Seidman, *Exchange Provisions of the Excess Profits Tax* (1941) 19 TAXES 75.

[13] Statement of Colin F. Stam, *Joint Hearings before the House Committee on Ways and Means and the Senate Committee on Finance*, 76th Cong., 3d Sess. (1940) 104.

[14] Of course, the comparison of present profits with those of a selected period of prior years would have to be abandoned. The relation of income to invested capital would necessarily be the basis of a permanent tax.

port for the view that income should be differentiated qualitatively as well as quantitatively for taxation. But if there were any clear way to isolate monopoly profits, it would probably be possible to prevent them from occurring in the first place. We do know that in an order of perfect competition, profits would differ among concerns due to a difference in the risk factor. In some lines of business most of the companies might make substantial profits all of the time while in other lines, profits would fluctuate from year to year and from concern to concern, depending upon the degree of success in the assumption of risks. No doubt there are unnecessary rewards in this picture, but no plausible technique for singling them out has yet been devised.

There are many ways to attack the monopoly problem. One is old-fashioned trust-busting; another is public regulation of selected prices; a third is public ownership; a fourth is joint public-private corporations in certain areas; and a fifth is the co-operative movement, which has had some success as a counter-monopoly program in Sweden. On top of these is the excess profits tax, a recapture program. This monopoly problem is clearly no easy nut to crack, and none of these approaches to a solution should be lightly abandoned. But the excess profits tax seems to be among the least promising.

The anti-monopoly movement, a very strong current in several eras of American history and still a vital force, might seek to check the concentration of economic power in several more specific ways. It might seek to limit: (1) the size of personal incomes; (2) the size of business units; and (3) the rate of business profits. Much can be said for the first of these objectives, particularly if it is attempted through progressive taxation and without any fixed arbitrary limit. Even the notion that there should be some upper limit to the size of the "catch" one can make in the economic stream, while a departure from tradition, can be defended in the name of many democratic values. As to the second objective, some businesses are undoubtedly larger than the social interest warrants; but it seems improbable that we know enough to restrict the size of business without doing more harm than good. And the last objective seems least promising of all. To limit the rate of profit is, in effect, to make preferred stock out of common stock. Undoubtedly the limited dividend corporation has its place as a voluntary institution. But to eliminate or largely eliminate by legislation the venture factor in business, seems quite inadvisable. The time may come when its preservation will be unnecessary but that state of abundance has not yet arrived.

There was much concern during the 'thirties over the weakness of the urge to invest and the failure of investment to revive substantially after the intense depression of the early years of the decade. Many suggestions were made for changing the tax system so as to make it more conducive to investment. No one ever proposed the excess profits tax for that purpose. To be sure it could be argued that such a program would rest lightly upon infant industries. But this would not weigh heavily against the discouragement to investment resulting from profits-tax penalties upon efficiency and successful risk-taking.

It has many times been observed that the social interest in less inequality of income may run counter to that in the encouragement of private investment. But the two interests may not be entirely in conflict. Taxes which are levied closest to the

operation of business and particularly those that are applied at the margin of operation are probably especially inimical to the incentives which are important to conserve. Taxes which are applied to the distribution of the end product are probably less repressive and they are also far more certain in their effect on inequalities. They would be even more certain if it were not for the inapplicability of personal taxes to the undistributed income of corporations.

III. The Role of Business Taxes in the Tax System

This leads to a consideration of the proper future role of business taxes in the tax system.

In the author's view there is very little gained by the imposition of heavy taxes on business. In the last analysis all taxes, including those levied on business, have to be paid by persons. The special benefits that business as such is supposed to receive are wrapped in obscurity as to their distribution, and it may well be that they are really general benefits enjoyed by all who have an occupation or any other source of livelihood. To be sure, these taxes serve the opportunistic end of filling the Treasury. But the ultimate incidence of these levies is quite obscure. Even the retail sales tax, the last resort of most public finance writers, is much less obscure than most business taxes in its incidence.

There are those who dislike the personal income tax because it is so well adapted for use in altering the distribution of income after taxes. To others this is the principal virtue of the tax. But to still others the income tax offers the supremely important virtue that it taps the income stream directly and offers a minimum of confusion as to incidence.

To those who would welcome greater emphasis on personal net income taxation, the problem of undistributed business income is a formidable impediment. It is plausibly argued that we must have the heavy emphasis upon business taxation as long as a very significant part of the economic product and the acquisition of economic power is detoured around the field to which personal taxation is confined. It will be recalled that T. S. Adams, after the last war, suggested that an undistributed profits tax be substituted for the excess profits tax. We experimented with a special tax on undistributed income in the late 'thirties with rather unhappy results. But the circumstances were so unpropitious and the instrument adopted was so crude that the experience can hardly be judged conclusive. Business itself might be well-advised to trade the excess profits tax and much of the present corporate net income tax for a well-framed undistributed income tax.

IV. Conclusion

The war excess profits tax, while open to valid objection, is probably warranted as an emergency measure; it has probably been pushed to the limit of safety in its present application; it will become less acceptable and should be mitigated when it can no longer be sustained by patriotism; its elimination should be attended by a revision of the whole business tax system, in which business taxes should be de-emphasized and a well-designed program to apply personal taxes to undistributed business income should be inaugurated.

EXCESS PROFITS TAXATION AND THE TAXPAYER

George Douglas*

Excess profits taxation goes hand in hand with warfare.

It need not be stressed that war requires great sums of money. As the Marshal de Trivulce said when Louis XIV asked him what he needed to make war—"Money, more money, and always money." Governments tap every available source of revenue in times of stress; what is more logical than a special levy on profits considered to be derived either directly or indirectly from the war effort.

Moral considerations in establishing excess profits taxation are also very great; in fact, they tend to dwarf the revenue aspect in most wartime discussions. In setting up an excess profits tax the emphasis is on "taking the profits out of war." The record has been generally one of hasty enactment, followed by revision in more or less substantial decree.

The record of World War I illustrates the popularity of the excess profits tax idea. Denmark and Sweden started the ball rolling in 1915 when they aimed a tax at the huge profits made on the shipment of goods into Germany. Within a year's time, seventeen countries had excess profits taxes on the books. Significantly, all these countries dropped this form of taxation from their fiscal systems when the war period terminated.

World War I Experience

Sacrifice and patriotism dominate the entire nation when we take up arms. Such things as imperfections in a tax system are relatively unimportant and rightly so. Most of the authoritative findings about the actual workings of World War I excess profits taxation in the United States had to await the Armistice, although some comment was made earlier.

Generally, the voice of authority was extremely critical. Secretaries of the Treasury McAdoo, Glass and Houston recommended repeal. Mr. McAdoo stated in 1918 to the House Ways and Means Committee:[1]

> The excess-profits tax must rest upon the wholly indefensible notion that it is a function of taxation to bring all profits down to one level with relation to the amount of capital invested, and to deprive industry, foresight and sagacity of their fruits.

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[1] *Hearings before the House Ways and Means Committee on the Revenue Act of 1918*, 65th Cong., 2d Sess. (1918) pt. 1, p. 15.

In his annual report as Secretary of the Treasury for the fiscal year ending June 30, 1919, Carter Glass, now the distinguished Senator from Virginia, declared:[2]

The Treasury's objections to the excess profits tax even as a war expedient (in contradistinction to a war-profits tax) have been repeatedly voiced before the committees of the Congress. Still more objectionable is the operation of the excess profits tax in peacetime. It encourages wasteful expenditure, puts a premium on overcapitalization and a penalty on brains, energy and enterprise, discourages new ventures, and confirms old ventures in their monopolies.

Secretary David F. Houston in the Treasury Department report for the fiscal year 1920 declared:[3]

The reason for the repeal of the excess profits tax should be convincing even to those who on grounds of theory or general political philosophy are in favor of taxes of this nature. The tax does not attain in practice the theoretical end at which it aims. . . . It is exceedingly complex in its application and difficult of administration, despite the fact that it is limited to one class of business concerns—corporations. Moreover, it is rapidly losing its productivity.

The 1919 report of the Federal Taxation Committee of the National Tax Association proclaims, "A general review of the entire subject of income and excess profits taxes leads us to doubt whether after all, a separate tax on excess profits should be imposed."[4]

Professor T. S. Adams of Yale, speaking with the benefit of his position as Chairman of the Advisory Tax Board of the United States Bureau of Internal Revenue, remarked at the 1919 Conference of the National Tax Association about the World War I excess profits tax then in effect:[5]

As a working measure of taxation, is it fit to survive? The more one knows about the actual operation of this tax, the more cautious he will be in answering this question. The doctrinaire, the taxpayer who knows the circumstances of his own case and no other, the all-wise publicist, with an instant opinion on every important problem ready—Like Postum, in one minute—will answer it lightly. Those who have studied the operation of the tax in thousands of cases, will hesitate to pronounce an opinion. The tax has the merit of being wonderfully productive. It is better than no tax at all; better than bonds to an equivalent amount. But it is decidedly not worth preserving for its own sake.

The taxpayer reaction to World War I excess profits taxation is epitomized in the 1920 report of the Tax Committee of the National Association of Manufacturers which asked[6] for repeal on the basis of

. . . a practical experience with this tax and its effect upon capital, upon labor, upon production, upon price and the enormous expense in preparing tax returns and collecting such a tax. . . .

[2] REP. SEC'Y TREAS. (1919) 23.
[3] REP. SEC'Y TREAS. (1920) 38, 39.
[4] NAT. TAX ASS'N, PROCEEDINGS OF THE 12TH ANN. CONF. (1930) 364.
[5] *Id.* at 306.
[6] NAT. ASS'N MFRS., 1920 TAX COMMITTEE REPORT, 15-16.

To mention some of the objections, we find the following significant indictments:

(1) Deprives industry of the fruits of its foresight and sagacity.
(2) It burdens brains, ability and energy.
(3) It discourages production.
(4) It penalizes enterprise and ingenuity.
(5) It interferes with the accumulation of industrial capital for the development of business.
(6) It encourages wasteful expenditures.
(7) It puts a premium on overcapitalization and a penalty upon conservative business practice.
(8) It discourages new ventures and confirms old ventures in their monopolies.

This last is particularly significant. Since all industries grow from small beginnings, they need encouragement and resources in the form of profits for future development. But the excess profits tax deprives industry of these encouragements and resources, repressing development and checking enterprise in its very beginning.

The Armament Maker First

There can be little denial that excess profits taxation originates in a critical atmosphere, if not in an atmosphere of outright hostility. It usually begins with a special levy on the "munition maker"—who is an unpopular figure at the time. The British duty on munition manufacturers profits of 1915 had its parallel in the United States tax of 1916 upon net profits from the manufacture of munitions. A general excess profits tax followed in both countries.

The pattern was the same in the present world conflict. Early in 1939 the British imposed a 60% excess profits tax on armament firms only when it began preparing for the present war. In the fall of 1939 this tax was extended to all companies. In a like manner, the French decree of April 1939 applied high rates only to profits earned by suppliers of materials used for national defense purposes. Five months later all profits were subjected to the tax.

The United States began by restricting profits on government contracts. The Vinson-Trammell Act,[7] approved March 27, 1934, and amended by the National Defense Act[8] of April 3, 1939, limited profits on contracts for naval vessels to 10% and limited profits on contracts for aircraft to 12%. These profit restrictions applied to government contracts in excess of $10,000. The Merchant Marine Act of 1936[9] contained profit limitations similar in most respects to those required by the Vinson-Trammell Act.

These statutes limiting the profits to be realized on contracts and subcontracts dealing with the manufacture of aircraft, vessels or parts thereof for the government, were suspended generally by Sections 401 and 402 of the Second Revenue Act of 1940—the so-called first Excess Profits Tax Act.

The report of the Ways and Means Committee of the House of Representatives, submitting the Second Revenue Bill of 1940, read in part:[10]

[7] 48 STAT. 505, 34 U. S. C. §496.

[9] 49 STAT. 1998, 46 U. S. C. A. §1155.

[8] 53 STAT. 560, 10 U. S. C. A. §311, 34, *id.* §496.

[10] H. R. REP. No. 2894, 76th Cong., 3d Sess. (1940) 15.

Since the proposed excess profits tax will apply to all corporations, including corporations now subject to the special profit-limiting provisions of the Vinson-Trammell Act, it is felt that such special provisions should not apply while the excess profits tax is in force. Uniformity will thereby be achieved in the treatment for tax purposes of all abnormal profits resulting from the national defense program.

There can be no quarrel with the intent of this last sentence. Certainly the tax payer gives hearty endorsement.

In passing it might be noted that some of the early support for an excess profits tax came from members of Congress and other groups who felt that this type of taxation would reduce pressure for the entry of the United States into the war then being waged in Europe. Bills were drafted and introduced with this purpose in mind.

Basic Attitude of Taxpayers Today

It has been my privilege to be very close to the thinking of businessmen, large and small, from all sections of the country, during the recent years in which the United States developed the present excess profits tax law.

To the best of my knowledge, no business executive opposes the principle of an excess profits tax which seeks to return to government exorbitant profits arising directly or indirectly from the war effort. This acceptance goes far beyond any public proclamations. Large numbers of industrial leaders have engaged in intricate computations and have considered numerous plans while exploring the possibilities of tax methods which would reach out for war profits.

The point I should like to emphasize is that those who operate the corporate businesses responsible for paying the present excess profits tax have not only accepted the basic principle involved; many of them have worked earnestly to help devise a specific form of tax which would collect the most money in the fairest manner and with the least injury to our economic structure.

It was in such a constructive attitude that the Committee on Government Finance of the National Association of Manufacturers approved[11] for submission to Congress very early in 1942 a proposal for a 90% tax on excess profits, together with a combined surtax and normal tax of 40% long before such a drastic excess profits tax rate was offered for consideration by the Treasury Department or any other agency in or out of the government.

I do not want to give the impression that industry-sponsored recommendations have the Alladin's lamp ability to eliminate all problems of taxpayers or that they were designed for such all-protective purposes. More properly, industrialists looked upon the excess profits tax as an imperfect mechanism which under the sharp prod of war necessity must be made to work as well as possible.

Appearing before the Ways and Means Committee in August 1940, when consideration was being given to a bill to raise a billion dollars additional revenue yearly to finance the recently initiated emergency national defense program, Carl N.

[11] See *Hearings before the House Ways and Means Committee on Revenue Revision of 1942*, 77th Cong., 2d Sess. (1942) Vol. 1, pp. 268-269.

Osborne, Vice-chairman of the N. A. M. Committee on Government Finance, stated:[12]

Although we favor a carefully drawn excess profits tax as an emergency measure, we wish to point out that the unsound nature of this type of taxation requires that we oppose it as a permanent part of the tax structure.

Livingston W. Houston, Chairman of the 1941 N. A. M. Committee on Government Finance, stated to the Ways and Means Committee in May of that year:[13]

The aim of the excess profits tax should be to reach out for profits arising from defense business, and although we recognize the tremendous difficulties of drafting a law which will achieve this aim with perfection, nevertheless we feel that even a partial achievement is more satisfactory than the complete abandonment of the principle of this law.

A few weeks after Pearl Harbor was bombed, a serious gathering of business executives began an overall study of the revenue needs of government. Out of their deliberations came a program which was put before the Way and Means Committee in March of last year by J. Cheever Cowdin, 1942 Chairman of the N. A. M. Committee on Government Finance. Mr. Cowdin said:[14]

We sincerely desire the Congress to draft a bill which will take from industry every last dollar of taxes that can be taken consistent with the tremendous war-production program of the Government....

As concrete evidence of industry's desire to bear additional taxes, we propose that Congress establish, in lieu of present taxes on income of corporations, the following three corporate taxes:

1. A war excess profits tax of 90 percent, applied after;
2. A normal tax upon corporation income at the rate of 18 percent; plus
3. A war tax upon corporation income at the rate of 22 percent.

This would establish a total rate of 40 percent on corporation earnings before application of excess profits taxes.

The foregoing statements should serve to illustrate the development of the taxpayers' basic attitude toward excess profits taxation in the United States beginning with the period of national defense and carrying through to our actual participation in warfare.

The Taxpayers' Problems

Although there has been general acceptance of the excess profits tax in principle, this should not give the erroneous impression that the life of the taxpayer has been all milk and honey under the various excess profits provisions in effect since 1940. No more complex or confusing language has ever been written into law; and in many phases, the expert has been as baffled as the layman.

[12] *Hearings before the House Ways and Means Committee on Excess Profits Taxation, 1940*, 76th Cong., 3d Sess. (1940) 319.

[13] *Hearings before the House Ways and Means Committee on Revenue Revision of 1941*, 77th Cong., 1st Sess. (1941) Vol. 2, p. 1651.

[14] *Hearings, supra* note 11, at 268-269

The smaller corporation—and this means by far the greater part of the 500,000 business enterprises in this form—is at a relative disadvantage when the law becomes so involved and its administration beset with so many pitfalls. It has been some wonder to me that the rank and file of business apparently has kept up to date with changes in the statutes since in the Second Revenue Act of 1940.

A highly specialized knowledge and competence is required to examine and intelligently apply the law which in many sections is a mass of mumbo-jumbo. Pity the taxpayer who picked up the Revenue Act of 1942 to find Section 740(g) amended as follows:

> (g) Component Corporations of Component Corporations.—If a corporation is a component corporation of an acquiring corporation, under subsection (b) or under this subsection, it shall (except for the purposes of section 742(d) (1) and (2) and section 743(a) (1), (2), and (3)), also be a component corporation of the corporation of which acquiring corporation is a component corporation.

Our lawmakers make no pretense of understanding, or even of reading, the tortuous passages of excess profits taxation which they enact. With all due respect for the difficulties of drafting legislation it seems unbelievable that the Internal Revenue Code cannot be clarified for the benefit of all concerned.

I am reminded of a comment by E. B. White, the oracle of Harpers Magazine. Mr. White had come across a sentence on Form 1040 which included, among other things, three sets of parentheses:

> That sentence, above, was obviously written by a lawyer in one of his flights of rhetorical secrecy. There isn't any thought or idea which can't be expressed in a fairly simple declarative sentence, or in a series of fairly simple declarative sentences. The contents of Section G of Form 1040, I am perfectly sure, could be stated so that the average person could grasp it without suffering dizzy spells. I would state it plainly myself if I could get some lawyer to disentangle it for me first. I'll make my government a proposition: for a five-dollar bill (and costs) I *will* state it plainly.

Special Problems

It would take a very exhaustive study to properly examine the innumerable problems of a special nature which were created when the Second Revenue Act of 1940 and subsequent excess profits tax measures went into effect. The practical application of the statutes brought to light many inequalities, uncertainties and ambiguities.

Early in 1941 the Committee on Federal Taxation of the American Institute of Accountants submitted recommendations for modification of the abnormality and reorganization sections of the Internal Revenue Code relating to excess profits taxes. The brief outline summary of these recommendations covers three pages of small type.

Later in 1941, after the enactment of a series of amendments to the law, the same Committee of the Institute made additional recommendations for technical and procedural modifications of the excess profits taxation under 31 separate headings. Without further detail, it should be evident that the taxpayer has had to face numerous

technical and procedural problems in the changing pattern of our excess profits tax laws.

The Invested Capital Method

An integral part of excess profits taxation is the concept of "normal" or base earnings. Two general methods are available for establishing the excess profits tax credit which measures the amount of base earnings over and above which the 90% excess profits tax applies.

Under the invested capital method the credit is established in the following manner:—

8% on the first $5,000,000 of invested capital, plus
7% on the next $5,000,000, plus
6% on the next $190,000,000 plus
5% on invested capital over $200,000,000.

This type of schedule definitely discriminates against the larger corporation as such without regard to sound tax principles, and is primarily motivated by the attack upon size and ability which has marked the social and economic reformers of the past decade.

The principle of penalizing a company with large invested capital, as a practical matter, discriminates against the small investor in the larger corporations as compared with both large and small investors in small corporations. Since large corporations usually have substantial numbers of small stockholders, this type of discrimination is of more than academic interest.

The Average Income Method

The optional method set up in the law allows the taxpayer to compute the excess profits credit either on invested capital or in relation to prior earnings. Corporations in existence before January 1, 1940, generally may use the average income of the 1936-1939 period in setting up their excess profits credit. There are many limitations and qualifications involved in the average earnings method which need not be examined here. The major objections to the present law voiced by taxpayers include:

(1) The average of three out of four years in the base period would establish a more proper base. This would be in line with British practice, where two out of three years of earnings in the base period may be used as a standard.

(2) The arbitrary 5% reduction in the average earnings of the base period is arbitrary and unsound. In practice the allowance of only 95% of the average base period net income may not be too serious, but as a matter of principle it has no justification.

Relief Provisions

The Congress has shown an admirable understanding of the need to protect those companies whose invested capital is so low and whose earnings record is so poor that

the regular methods of establishing a measure of "normal" earnings would result in serious hardships.

The broad relief provisions in the 1942 law promise to give relief to a great number of companies whose base credits are abnormally low. Under these provisions many companies may establish more adequate yardsticks of normal earnings and diminish their liability for excess profits taxes.

Under Section 722 of the Internal Revenue Code companies are entitled to relief where factors affecting the business resulted in an inadequate standard of normal earnings. Specific consideration is given where:

1. Production was interrupted or diminished in the base period because of unusual and peculiar events.

2. Temporary economic circumstances depressed base period earnings.

3. Conditions prevailing in the industry created a profits cycle differing from the general business cycle, or where the taxpayer's industry did not enjoy a prosperous year, although dependent upon such a good year at irregular intervals.

4. The taxpayer commenced business, changed the operation or management of the business, made a difference in the products or services furnished, changed the ratio of borrowed capital to total capital, or acquired before January 1, 1940, the assets of a competitor.

It is clear that the burden of proof under the relief sections is upon the taxpayer. Whether or not the intended relief will be granted depends, in a very important degree, upon the character and the ability of those who administer the tax law. It also involves such basic considerations as a generally sympathetic attitude towards the profit motive and the future of the private enterprise system.

The War Period and the Future

The drastic nature of excess profits taxation, considered with other heavy taxes upon business concerns during this war period, has resulted in serious strains upon productive enterprise. The impact of these taxes affect:

(1) The ability of companies to retain sufficient earnings in the business after taxes are paid to carry on maximum war production, and

(2) The ability of enterprises to build up sufficient reserves to cushion the effect of transition to peacetime production, to continue operations and to provide jobs in the post-war period.

In order to produce the greatest volume of war material ever turned out by any country in the world, American industry required a comparable amount of financing. With increased production came increased receivables, higher inventories, plant extensions and new machinery required in the war effort. Employment and payrolls jumped tremendously. The funds to meet these production demands had to come from some place or operations would have stopped.

The banks and the government necessarily supplied the bulk of funds needed to carry out the gigantic war production program. Retained and accumulated earnings also helped finance the expanded war effort in substantial degree, just as they financed the great development of our peacetime industry.

Debt obligations must be met out of what companies have left after taxes—in other words, industry can be made insolvent if taxes get so high that borrowings cannot be repaid.

Under the existing corporation normal tax, surtax and excess profits tax, companies generally will have available after taxes about 3% out of total business receipts left to keep war materials flowing, pay some dividends to 11,000,000 stockholders, and have sufficient reserves to reemploy our fighting forces, retool and make new goods after the war.

Definite signs of financial strain are already evident. A study of 100 of the larger manufacturing companies released earlier this year by the National City Bank shows that the conversion to war production was accompanied by a substantial increase in inventories and receivables, with a corresponding increase in tax reserves and other liabilities and a consequent decrease in liquidity.

The margin between maximum taxation and overburdening taxation is very slim. The entire nation has a vital stake in seeing that industry has sufficient resources after taxes to do a maximum war production job and to continue operations through the critical days when the war is over.

A cold, factual attitude on excess profits taxation will help maintain peak war production and preserve future solvency.

TAX PROBLEMS OF WARTIME PLANT EXPANSION

THOMAS E. JENKS*

At the outset of the defense program, in 1940, providing the physical facilities necessary for war production was a critical problem. Three plans were developed to meet this need by members of the Advisory Commission to the Council of National Defense.[1] The first involved the construction of new plants wholly with private funds. In order to encourage the use of this plan, it was proposed that taxpayers providing facilities under it be permitted to deduct the cost of such facilities, for tax purposes, over a five-year period. The second plan involved the use of private funds at the outset, with the builder thereafter being reimbursed directly by the Federal Government for his expenditures, in periodic payments over a five-year period. After the war, the facilities were to belong to the Government unless the builder chose to buy them back. The third plan provided for direct and complete financing by the Government, with full government ownership at all times. Facilities constructed under this plan would be leased to private companies for management and operation.

These three plans have provided the basis for all wartime plant expansion. They are commonly referred to, respectively, as the "Amortization" plan, the "Emergency Plant Facilities" plan, and the "Government Ownership" plan.

Contrary to general expectations, private capital has not shouldered the heaviest load. As of December 31, 1942, total commitments for industrial facilities expansion amounted to $19 billions, of which approximately $4.3 billions was privately financed, with the aid of amortization or Emergency Plant Facilities contracts.[2]

To what extent tax difficulties have contributed to this result remains a matter for speculation. Each of the plans involves tax problems, which will be considered herein.

I. AMORTIZATION

The Second Revenue Act of 1940 added a new provision to the Internal Revenue Code, Section 124, designed to implement the amortization plan by permitting tax-

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[1] See *Hearings before the Senate Committee on Finance on H. R. 10413*, 76th Cong., 3d Sess. (1940) 181, 186.

[2] These figures are obtained from unofficial sources. Figures as of Oct. 31, 1942, are published by the U. S. Office of War Information, in 4 VICTORY, No. 4, p. 17 (Nov. 29, 1942).

payers to deduct, over a 60-month period, the cost of facilities constructed or acquired in the interest of national defense during the emergency period.

It is perhaps desirable at the outset to consider briefly the necessity for a statutory provision. The tax laws have always granted a deduction for the depreciation of buildings, machinery and other business property.[3] The probable useful life of the property is estimated, and its cost is spread over this period. However, the Treasury Department and many taxpayers felt that the probable useful life of a facility devoted to war purposes could not readily be determined under existing law.[4] Such a determination would require an estimate of the probable duration of the emergency and also an estimate of the probable usefulness of the facility after the war—both highly uncertain factors. Accordingly, it was determined that a statutory provision should be enacted.

Both the Treasury and taxpayers had unhappy memories of their experiences with amortization during and after the World War. The Revenue Act of 1918 contained a provision permitting taxpayers to deduct the loss of useful value of facilities erected after April 6, 1917, for the production of articles contributing to the prosecution of the war.[5] This provision presented two very difficult problems: (1) Whether the particular facility was necessary for the prosecution of the war, and (2) what was the remaining value of the facility after the war. These problems resulted in confusion during the war and in extended litigation for years after the war.

Section 124 was drafted to avoid, so far as possible, the pitfalls of the earlier act. The section expresses a basically simple policy in complicated statutory language. The basic policy is to determine the necessity for a war facility in advance, and to substitute a five-year period for the indefinite period of depreciation otherwise prescribed by statute.

The mechanics by which this policy is carried out are as follows: The taxpayer must obtain a certificate (called a "Necessity Certificate") from either the Secretary of War or Navy that the facility is necessary in the interest of national defense during the emergency period. Applications for such certificates ordinarily must be filed within six months from the beginning of construction, or the date of acquisition, of the facility.[6] Having obtained a Necessity Certificate, the taxpayer may elect to take the amortization deduction over a period of 60 consecutive months, beginning either with the month following completion of the facility, or with the first month of the succeeding taxable year. This election is exercised in the tax return for the year in which the taxpayer desires to begin the amortization deduction. Once having elected

[3] INT. REV. CODE §23(l).

[4] See statement of the Hon. John L. Sullivan, Asst. Secretary of the Treasury, *Joint Hearings on Excess Profits Taxation, Amortization, and Suspension of the Vinson-Trammell Act*, 76th Cong., 3d Sess. (1940) 74 *et seq.*

[5] Rev. Act of 1918, §§214(a)(9), 234(a)(8).

[6] There are certain exceptions to this rule. Applications with respect to facilities completed or acquired after Dec. 31, 1939, and before June 11, 1940, by a corporation, or after Dec. 31, 1939, by an individual or partnership, must have been filed before April 22, 1943. Rev. Act of 1942, §155(e)(2). Applications filed after the expiration of the six-months period are timely with respect to the part of the facility constructed within six months prior to the filing date. *Id.* §155(d).

amortization, the taxpayer must continue to take the deduction on a monthly basis, unless, prior to the beginning of any month, he notifies the Commissioner of Internal Revenue that he desires to discontinue the deduction. If the amortization deduction is discontinued, it cannot thereafter be resumed. If, however, the war emergency is declared at an end prior to the expiration of the 60-months period, the taxpayer may elect to recompute the deduction, using the shorter period of the emergency instead of the 60-months period. This he may do although he has previously elected to discontinue amortization, or although, after receiving a Necessity Certificate, he has never elected amortization. The right of recomputation may be exercised even though it involves reopening returns otherwise barred by the statute of limitations.

On the whole, these provisions are obviously beneficial to the taxpayer. The major difficulties encountered in the administration of the 1918 Act have been avoided. However, amortization has proved to be a hydra-headed problem. In place of the problems disposed of by the legislation, new problems of interpretation have sprung up.

(1) *Depreciation or Special Allowance?*

The earliest, and perhaps the most violent controversy concerned the nature of amortization. Amortization was regarded by some as a government subsidy to industry, a reimbursement of the cost of war plants to the extent of the tax deduction. This viewpoint was rather widely held during the early consideration of the amortization provision, and influenced Congress to insert a special provision in Section 124 dealing with "reimbursement."[7] This provided, in substance, that if the taxpayer were being reimbursed by the United States for the cost of a facility, amortization would be denied unless the contract providing for reimbursement adequately protected the United States with reference to the "future use and disposition" of the facility. To enforce this provision, the service departments were directed to issue two types of certificates with respect to individual contracts with the United States of taxpayers claiming the amortization deduction: A "certificate of non-reimbursement," that the contract did not provide for reimbursement by the United States, or a "certificate of Government protection," that the contract adequately protected the Government's interest. In the absence of one or the other of these certificates, the taxpayer was left in the uncomfortable position of having to prove to the Treasury Department that none of his contracts with the United States reimbursed him for any part of the cost of any facility subject to amortization.

There is considerable evidence that the legislative committees of Congress intended to confine the application of this provision to the Emergency Plant Facilities type of contract, where the reimbursement by the United States is direct and specific, and to those supply contracts where the parties, by agreement, "loaded" the price with the cost of the facilities required to perform it.[8] The provision was early interpreted,

[7] Second Rev. Act of 1940, §302.

[8] See, H. R. REP. No. 1207 on H. J. Res. 235, 77th Cong., 1st Sess.; and *Hearings before the House Committee on Ways and Means* on H. J. Res. 257, 77th Cong., 2d Sess. (1942).

however, to require the examination of every supply contract to determine whether, in fact, it contained a charge in excess of "normal" depreciation. As so interpreted, the administration of the provision was a hopeless task, since every supply contract showing a profit was open to suspicion. The service departments were remanded to a consideration of the elements of a "reasonable" profit, without any standards for guidance. A series of "clarifying" amendments failed to remove the difficulties,[9] and the provision ultimately was repealed.[10]

Since the questions are now academic, the subject does not warrant an extended discussion. It is sufficient to observe here that the belief that amortization is some form of subsidy arises from confusion as to the nature of the deduction. The only way in which the cost of any productive facility is ever recovered is through the proceeds of sale of the product. The tax laws have always permitted a portion of such proceeds to be recovered tax-free, through the allowance of a deduction for depreciation. The depreciation deduction is not regarded as a subsidy, or as a "double reimbursement" of cost. Amortization is merely a deduction in lieu of depreciation. If the facility actually is operated after the expiration of the amortization period, no depreciation deductions will be allowed. No part of the cost of any facility may be recovered more than once. In return for increased deductions over a five-year period, the taxpayer gives up all deductions thereafter. The aggregate amount of deductions is not increased. There is no "subsidy" in such an allowance, although, in common with many other deductions, it may result in a tax benefit.

The question has arisen whether, since the repeal of the "non-reimbursement" provisions, a charge for amortization of war facilities may be made in supply contracts, either of the "fixed-price" or the "cost-plus" type. It is submitted that this question has no logical connection with the amortization deduction. The proper charge for depreciation in a supply contract depends on the judgment of the contracting parties regarding the probable useful life of the particular facilities involved. It may be that a charge equivalent to the amortization deduction is justified, if the facilities will not be useful after the war. But this question cannot be answered by reference to the tax statutes.

A similar question may be expected to arise in connection with various statutory or contractual provisions which permit the Government to purchase or requisition various types of property at "depreciated cost."[11] If the property is subject to amortization, should the payment be based on cost less depreciation or cost less amortization? This question, too, should be resolved without recourse to the tax law. The object of such provisions is to set a fair value upon the property, which is normally measured by the actual physical depreciation sustained and not by the basis used for tax purposes. Of course, it necessarily follows that the excess of the purchase price

[9] Act of Oct. 30, 1941, 77th Cong., 1st Sess., c. 464 (H. J. Res. 235).
[10] Act of Feb. 6, 1942, 77th Cong., 2d Sess., c. 41 (H. J. Res. 257).
[11] See, *e.g.*, Emergency Plant Facilities Contract, Draft of Oct. 10, 1940, art. III, §2(a); Merchant Marine Act, 1936, §802.

over amortized cost will be regarded as taxable income at the time of purchase or requisition.

(2) *Problems of Certification*

The primary determination under Section 124 is the necessity of the facility for war purposes. The statute provides no criteria for this determination, except that the facility must be "necessary in the interest of national defense during the emergency period."[12] The determination is made by the War and Navy Departments, under joint regulations approved by the President.[13] The discretion of the service departments probably is not reviewable.

In practice, decisions are made by a staff of reviewers in special sections of the War and Navy Departments, principally on the basis of reports rendered by the appropriate procurement branches of the services, and by the War Production Board. Applications for an amount in excess of $250,000 must be reviewed by a Tax Amortization Committee of the WPB.[14] In the War Department, novel or difficult questions may be referred to a Special Panel composed of disinterested persons not connected with the Department.[15]

Under the policies developed by the Tax Certification Sections, both the article to be produced and the facilities to produce it must be demonstrated to be essential to the war effort. The article to be produced is necessary if it is essential to the armed forces, lend-lease nations, or civilian defense.[16] Civilian supplies may be necessary if they contribute directly to the operation of a war facility, or if they release supplies needed for war purposes.[17] For example, air-conditioning of a laboratory in a war plant might be necessary, while air-conditioning of offices in the same plant would not be.

The facilities to produce necessary articles will be certified only if there is a shortage of capacity to produce such articles in the industry as a whole.[18] The situation of the individual company is immaterial. Thus, if there is idle capacity in other plants, or if the applicant has other facilities which can be converted to war work, or if the production can be subcontracted, a Necessity Certificate will not be granted. Exceptions are sometimes made, based on geographical considerations preventing the use of theoretical capacities or on special qualifications of the taxpayer requiring use of his facilities despite the existence of apparently adequate capacity.[19]

The time when a shortage of capacity is determined may be of vital importance. The Regulations state that the shortage may be either existing or prospective, and will be considered either at the time of the expansion or at the time of the issuance of

[12] §124(f)(1).

[13] Joint Regulations have been prescribed. 7 FED. REG. 4233 (June 4, 1942).

[14] *Id.* §4b. There is no statutory authority for this Committee. On the contrary, the Advisory Commission to the Council on National Defense, to which the War Production Board has succeeded, was eliminated as a co-certifying agency by H. J. Res. 235, *supra* note 9.

[15] This Committee is not mentioned either in the statute or the regulations. An advisory committee, it also exercises what amounts to an appellate jurisdiction within the Department.

[16] *Id.* §3a.

[17] *Id.* §3a, iii.

[18] *Id.* §3b, i(1).

[19] *Id.* §3b, ii.

a Certificate.[20] However, the Tax Certification Sections have denied a Certificate in several cases where the expansion preceded the development of a war need. These cases appear to belie the Regulations and are difficult to explain except on the ground of the applicant's motive for the expansion, which should not be material. In the converse case, where the facilities are clearly necessary at the time of expansion, but subsequently lose their value to the war effort, Necessity Certificates have been granted. This result seems obviously just, although it may be inadequate if the taxpayer does not have other income against which the cost of the prematurely useless facilities may be amortized. However, after a Necessity Certificate has been granted, the taxpayer may apply at any time to the War or Navy Departments for a certificate that the facilities are no longer necessary for national defense.[21] If the latter certificate is granted, the taxpayer may recompute the deduction for amortization over the period from the completion of the facilities to the date specified in such certificate,[22] or, if the facilities have not been completed, from the beginning of construction to the date stated in the certificate.[23] These provisions recognize the growing number of cases where changes in the war program have forced the cancellation of projects formerly deemed essential.

The transfer of facilities from one taxpayer to another has caused a great deal of difficulty. Where the facilities have not previously been certified, the general policy of the Tax Certification Sections has been to deny a Necessity Certificate, unless the taxpayer can show that the facilities have an "increased usefulness for national defense" in his hands.[24] This treatment is a corollary of the proposition that the Tax Certification Sections are concerned solely with the net increase of industry capacity, and not with the situation of the individual taxpayer. "Increased usefulness" may be shown by evidence that the facilities were idle in the hands of the prior owner or were used by him for a non-war purpose. Frequently, however, the taxpayer does not have adequate knowledge of the prior use. Moreover, in the case of machine tools, railroad equipment, ships, and other vital war material, the taxpayer will find it difficult to prove that the equipment is more necessary to the war effort in his hands than it was to the prior owner. In view of the increasing difficulty of obtaining new equipment, and the need for wider utilization of existing productive capacity, a re-examination of this policy would seem to be desirable.

The transfer of facilities covered by a Necessity Certificate also creates problems. The Treasury Department has ruled in several instances that assets subject to a Necessity Certificate may be transferred in a tax-free reorganization without obtaining a new Certificate.[25] No such assurance exists in other types of transfers, and, as a practical matter, most taxpayers have sought new Certificates. This has the result of starting a new amortization period, regardless of how long the prior owner has

[20] *Id.* §3b, i.

[21] INT. REV. CODE §124(d)(1).

[22] *Id.* §124(d)(4).

[23] *Id.* §124(d)(6).

[24] JOINT REG. OF THE SEC'Y OF WAR AND THE SEC'Y OF THE NAVY, §3c, iii (hereafter cited as "JT. REG."). Transfers between related taxpayers are, of course, closely scrutinized, and seldom have been certified.

[25] The rulings are unpublished.

held the emergency facility. It also creates, in most instances, a new basis for amortization. There are obvious possibilities of manipulation in this situation. The simple and logical rule, which the service departments are understood to favor, is that the Certificate attaches to the facilities in all cases and is automatically transferred with them. This would be consistent with the Government's position that it is the facility and not its owner which is important to the war effort.

Replacements of existing facilities are also controversial. After a period of indecision, the Tax Certification Sections decided that replacements would not be certified if it is established that they would have been made under normal peacetime conditions.[26] This is a sound rule, but its application requires some degree of clairvoyance. There are many types of replacements, and full depreciation or obsolescence is seldom the sole contributing factor. Replacements may be made to modernize plant, to remove "bottlenecks" in a production line, to eliminate hazardous conditions, to prevent break-downs, to restore property destroyed. Which of these types of replacement would have been made, under "normal peacetime conditions?" Furthermore, even if depreciation or obsolescence is the primary cause, this does not settle the problem. Three-shift operation required in wartime may have hastened depreciation, or wartime technological improvements may have rendered the property obsolete. The replacement may be of better design or larger size than the old equipment, so that plant capacity is increased. The replaced asset may not be retired but may be shifted in the plant to lighter or less precise work. The Tax Certification Sections have struggled with these problems as they arose, deciding each case on its own facts. Perhaps the difficulties are inherent; but a clearer policy is badly needed.

Land occupies a unique position, since it is subject to amortization but not to depreciation.[27] It is understood that the inclusion of land was dictated by the difficulties encountered during the World War in inducing the acquisition of land for shipbuilding purposes, and by the desire to encourage the construction of airports, channels and similar facilities.[28] Despite this legislative history, the Regulations provide that land will be certified only if it is directly connected with necessary production facilities.[29] Nevertheless, airports have been certified; also, storage areas, parking lots and waste disposal areas. Farm land has been denied certification. The purchase of land in excess of immediate production needs will not be certified, except where the taxpayer is compelled to buy on an "all or nothing" basis. Oil and mining property subject to the depletion allowance provided by Section 23(m) of the Code will not be certified, since the statutory deduction for amortization is "in lieu of the deduction (for depreciation) . . . provided by Section 23(l)."

[26] JT. REG. §3c, v. Note the phrasing of this regulation, which suggests that the Government has the burden of establishing the peacetime character of the replacements.

[27] U. S. TREAS. REG. 103, §19.23(l)-2. Land is specifically included in the definition of an "emergency facility," INT. REV. CODE §124(e)(1).

[28] See H. CONF. REP. No. 3002, 76th Cong., 3d Sess. (1940) p. 58.

[29] JT. REG. §3c, ii.

(3) *Problems of Interpretation*

The functions of the Tax Certification Sections begin and end with the determination of "necessity." Since Section 124 is a part of the Internal Revenue Code, the primary responsibility for its interpretation rests with the Treasury Department. But few rulings have been published, and it is too early for litigation. As a result, many important problems remain unanswered.

For example, the definition of a "facility" has never been settled. This is perhaps the most fundamental determination the taxpayer is called upon to make. He must decide what the "facility" is, in order to file a timely application for a Necessity Certificate; to identify the subject-matter of the Certificate with sufficient precision to satisfy the Commissioner upon audit of his return; and to determine when to begin the amortization deduction.

The statute defines an "emergency facility,"[30] somewhat tautologically, as "any facility, land, building, machinery, or equipment, or part thereof, the construction, reconstruction, erection, installation or acquisition of which was completed after December 31, 1939, and with respect to which a certificate . . . has been made." The definition indicates that land, buildings, and machinery, which are separately enumerated, are probably separate facilities. It also indicates that work performed, such as reconstruction or installation, may be a facility separate from the asset itself. Thus, the purchase of machinery and its installation may be two distinct facilities within the meaning of the statute.

Many taxpayers have adopted the view that each depreciable asset constitutes a facility. While this theory does not entirely square with the statutory definition, it seems to be the most logical approach, since amortization was intended as a substitute for depreciation. It is certainly the most convenient for record-keeping purposes. Under this approach, for example, the purchase and installation cost of a machine (and perhaps also the cost of constructing foundations) would be treated as a single facility, since they are normally combined for depreciation purposes. There is also a broader view, which has its supporters, that it is the entire group of assets making up a complete plant or productive unit, which constitutes the facility.

If the analogy to depreciation is accepted, it does not necessarily follow that every depreciable asset must be described in the Necessity Certificate. On projects of any size, Certificates are normally issued before or during construction, when complete identification of the facilities is a virtual impossibility. The Tax Certification Sections urge taxpayers to furnish supplemental detail, as soon as complete data are available, which they will transmit to the Commissioner as a supplement to the Certificate. This is obviously a wise precaution. Even in the absence of such data, however, the taxpayer should be permitted reasonable latitude both in description and enumeration. The Certification Sections are not equipped to consider the necessity of an expansion program down to the last nut and bolt. If the taxpayer clearly describes the project and its major components, the identification should be adequate, provided the facilities

[30] INT. REV. CODE §124(e)(1).

actually installed can subsequently be related to the Certificate through authorization numbers, asset numbers, or other accounting data. It is also generally agreed that minor variations in actual costs from the costs estimated in the Certificate are immaterial, since it is the facilities and not the cost thereof which are certified to the Commissioner. The principal hazard involved in variations, either in description or costs, is that they may indicate substantial changes in, or additions to, the program after certification. The statute expressly requires that any expenditure attributable to a facility after certification shall not be added to the amortization basis, but shall be certified as a separate facility.[31]

Other troublesome phrases in the statute are the "beginning of construction," the "date of acquisition," and the "date of completion."

A Necessity Certificate has no effect unless the application therefor was filed within six months after the beginning of construction or the date of acquisition of a facility.[32] The harsh effect of this provision, however, has been mitigated by an amendment in the Revenue Act of 1942 which permits amortization of the part of a facility constructed within the six-months period, regardless of the filing date.[33]

The difficulties may be illustrated by the construction of a building. The "beginning" of such construction might be the date of drawing plans and specifications, awarding the construction contract, clearing the site, excavating for the foundations, or erecting steel. There seems to be no disposition to treat "paper" work in advance of physical operations as the beginning of construction. Whether operations on the site or foundation work will be so regarded may depend on the taxpayer's depreciation practice. If the taxpayer depreciates these expenditures with the building cost, it is quite likely that the date when they were commenced will be treated as the beginning of the building.

In order to fix the starting-point for the amortization deduction, the taxpayer must also ascertain the date when the facility was "completed or acquired."[34] In general, "completion" involves two possibilities: The date of physical completion or the date of beginning operations with the facility. In the normal case, where physical completion and operation are reasonably close together, the taxpayer probably can select either date if he follows it consistently.[35] However, if the facility is not used for a long period after physical completion, the latter should be controlling. A taxpayer who constructed a building in 1940, should not be able to claim amortization by putting the building into service in the current month, unless the delay was due to lack of raw materials, or other causes beyond his control.

The date of "acquisition" of a facility presents some special problems, because of the additional factor of passage of title from a prior owner. An "acquisition" might occur on (a) the date on which a firm order or binding contract was executed, (b) the

[31] *Id.* §124(f)(2).
[32] *Id.* §124(f)(3).
[33] Rev. Act of 1942, §155(d). Strictly speaking, no application can now be filed more than six months after the beginning of the "facility," as that portion constructed within six months preceding the filing date is defined by this amendment as a separate "facility."
[34] INT. REV. CODE §124(a).
[35] There are unpublished rulings to this effect.

date when title passed to the purchaser, (c) the date of physical receipt, or (d) the date of actual use or operation.

It seems very improbable that the execution of an order or a contract will be considered an acquisition. Nor is it likely that the Treasury Department will insist upon technical refinements of the law of sales, such as the passage of title upon delivery to the carrier, etc. Under a practical administration of the law, in line with depreciation practice, the same test should be used for acquisition as for completion, that is, the date of beginning operation with the facility—again assuming that there is no unreasonable time lag between receipt and actual use. It should be noted, in this connection, that acquisitions of steel, lumber, and like materials accumulated in inventory for construction purposes would not ordinarily be considered "facilities" since they are not depreciated until charged to construction. Where such materials are actually used within a reasonable time, their cost should be amortizable upon the completion of the construction.

The acquisition date of land is also difficult to determine. The date of acquisition would not appear to be earlier than payment of the purchase money, since the taxpayer would have no investment in the property prior to that date. If the taxpayer pays part of the purchase money and takes possession, acquisition probably occurs despite the seller's retention of a security title. If payment precedes both title and possession, a more difficult question is presented. Probably the taxpayer has not acquired property unless he has at least the right to immediate possession.

After identifying the facility and determining the starting date for amortization, there remains the question of the proper basis. Normally, of course, the amortization basis is the same as the basis otherwise determined, that is the basis prescribed in Section 113(a) of the Code, with the adjustments prescribed in Section 113(b). However, Section 124(f) further limits the basis to the amount "properly attributable to such construction, reconstruction, erection, installation, or acquisition after December 31, 1939, as either the Secretary of War or the Secretary of the Navy has certified as necessary in the interest of national defense during the emergency period. . . ." Thus, if construction began before December 31, 1939, and ended after that date, only the part of the cost which is attributable to construction after that date is subject to certification. Furthermore, the Tax Certification Sections may certify that only a specified percentage of the cost incurred after the basic date is necessary for national defense—for example, where the taxpayer constructs an unnecessarily expensive building, or where the facility will be used only part time for war purposes.

The Tax Certification Sections have held that the proper method of allocation of costs before and after the basic date should be determined by the tax authorities. The Treasury Department Regulations, however, throw no light on this problem.[36] The phrasing of the section suggests that the distribution should be made on an engineering basis, with regard to the physical construction actually occurring after the basic date. Since this is usually impracticable, most taxpayers have distributed

[36] U. S. TREAS. REG. 103, §19.124-6.

costs before and after the basic date on the basis of costs accumulated on the books, or on work orders kept while construction was in progress. Another possibility is a distribution on the basis of actual expenditures, although this method unduly favors the taxpayer if payments are not made promptly after performance of the work.

Wherever a portion of the basis is excluded from certification, the excess is subject to normal depreciation.[37] The regular adjustments to basis prescribed in Section 113(b) must be made, and allocated between the depreciable base and the amortizable base, where both deductions are applicable.[38] An adjustment for normal depreciation must also be made for any period prior to the election of amortization.[39]

A special situation arises where the taxpayer elects amortization with respect to a facility before he has received a Necessity Certificate. Here, the Treasury Department has ruled that no deduction for amortization may be taken for any month prior to the year in which the Certificate is actually issued, but that the amortization period nevertheless starts with the month specified in the election, even though it falls in a prior year.[40] Thus, a premature election may have the surprising result of increasing the monthly deduction for amortization while shortening the amortization period.

(4) *1942 Amendments*

Two other important amendments to the amortization provisions were adopted in the Revenue Act of 1942. The deduction was extended, retroactively, to individuals and partnerships, where it had previously been limited to corporations.[41] The basic date for amortization was regressed from June 10, 1940 to December 31, 1939, thus permitting certification of essential defense installations made prior to the first public announcement of the amortization policy.[42] Applications for certification of such facilities must be filed before April 22, 1943, and Necessity Certificates therefor must be issued prior to October 22, 1943.[43] Taxpayers establishing their right to amortization of costs incurred in this period will be able to obtain refunds of 1940 and 1941 income and excess profits taxes, without interest.[44] The cost incurred between December 31, 1939, and June 10, 1940, is treated as a separate facility.[45] Hence, if a corporate taxpayer has failed to apply for certification of a facility completed after June 10, 1940, only the portion of the cost incurred before that date may now be certified.

II. GOVERNMENT REIMBURSEMENT

The Emergency Plant Facilities Contract was an attempt to provide a dual method of financing under which private capital would provide the initial funds, subject to reimbursement by the Government over the assumed period of the emergency. This contract was designed for the type of expansion with a high degree of capital risk, such as powder plants, tank factories and similar facilities with no post-

[37] INT. REV. CODE §124(g).
[38] U. S. TREAS. REG. 103, §19.124-6, Example (2).
[39] *Id.*, Example (1).
[40] *Id.* 103, §19.124-2, Example (3).
[41] Rev. Act of 1942, §155(a).
[42] *Id.* §155(d), (e).
[43] *Id.* §155(e)(2).
[44] *Id.* §155(j).
[45] *Id.* §155(e).

war utility. The facilities required for the expansion are listed in detail in the contract. Upon completion of the project, the Government agrees to reimburse the contractor for the cost of such facilities in 60 consecutive monthly payments. Title to the facilities is in the contractor during this period. The contract can be terminated by the Government at any time, or by the contractor under specified conditions. Upon termination, the facilities must be conveyed to the Government, unless the contractor exercises an option to buy them at cost less depreciation or at an agreed price. If the facilities are intermingled with the contractor's facilities, the Government may be required to remove them.

This method of financing has never received wide acceptance. Direct government ownership proved to be more practical for this type of expansion. As of November 30, 1942, only 128 plants had been built with the aid of EPF contracts, involving a total expenditure of $336 millions.[46] Nevertheless, they involve an interesting tax problem, which concerns the nature of the reimbursement payments.

The Treasury Regulations[47] provide as follows:

> Amounts received by a taxpayer in connection with its agreement to supply articles for the national defense, though denominated reimbursements for all or a part of the cost of an emergency facility, are not to be treated as capital receipts but are to be taken into account in computing income, and are therefore not to be applied in reduction of the basis of such facility. . . .

Thus, the taxpayer is required to include EPF payments in gross income. As an offset, he may obtain a Necessity Certificate for the expansion, which, in theory, permits him to take a deduction for amortization each month equal to the amount of the reimbursement payment. Actually, the deduction may not be correlated with the income since the term "completion," as used in EPF contracts, appears to refer to the entire expansion, while the amortization deduction, as previously noted, may begin with the completion of individual facilities. To avoid this distortion, the Treasury Department has ruled in some instances that the "facilities" described in the EPF contract may be amortized as a group, thus gearing the deductions to the EPF payments.[48]

The Treasury's position that the EPF contract is not a contract of sale requires some explanation. It is understood that the Treasury feels that the usual EPF contract provisions with respect to ownership of the facilities are ambiguous. The contractor owns the facilities during the period of the contract. The Government does not acquire them unless the contract is terminated, and no specific termination date is prescribed. In some cases, the Government may not be able to obtain the facilities except by removing them, and removal may be impossible or may require destruction of the facilities. In view of this doubt as to ownership, the Treasury Department believes that the substance of the transaction is a payment for war material rather than a purchase of facilities.

[46] These figures were obtained unofficially from records of the Tax Certification Sections.

[47] U. S. TREAS. REG. 103, §19.124-6.

[48] The rulings are unpublished.

Even if this ambiguity exists, it is still difficult to reconcile the Treasury Regulation with a long line of cases holding that a government contribution to the capital of a taxpayer, to be used for the completion of a plant or as reimbursement for similar capital expenditures, is not income to the taxpayer. The leading case is *Edwards v. Cuba Railroad Company*,[49] in which the Cuban Government contributed money and property to a railroad to aid it in constructing and operating a line over specified routes. Similar cases involve payments by shippers to railroads to obtain the construction of spur track,[50] contributions by rural residents to utility companies for the extension of electric power lines into their community,[51] and contributions by boards of trade or other public groups to induce new industries to settle in their district.[52] In none of these cases did the donors of the contribution or subsidy obtain title to the facilities when constructed.

The Treasury Department apparently distinguishes these cases on the ground that the payments for emergency facilities are made primarily to obtain supplies needed by the Government, and thus have the character of payments for goods or services. EPF contracts, almost without exception, are made in connection with supply contracts, and sometimes may be physically incorporated in the same document. Reliance is thus placed on cases in which government payments were held to be operating subsidies or additional compensation rather than capital contributions.[53] The soundness of the Treasury's position seems questionable in view of the fact that EPF payments are carefully segregated from supply payments and are expressly conditioned on construction work performed, and the further fact that supply concessions or other preferential treatment to the donor were involved in *Cuba Railroad* and other cases.

Recently, however, there has been some indication that the doctrine of *Cuba Railroad* may be whittled down, at least insofar as it applies to government payments.[54]

[49] 268 U. S. 628 (1925).

[50] Great Northern Ry., 8 B. T. A. 225 (1927) *aff'd*, 40 F. (2d) 372 (C. C. A. 8th, 1930), *cert. den.*, 282 U. S. 855 (1930); Texas and Pacific Ry., 9 B. T. A. 365 (1927); Atlantic Coast Line R. R., 9 B. T. A. 1193 (1928); Kansas City Southern Ry., 16 B. T. A. 665 (1929), *aff'd* and *rev'd* on other points, 52 F. (2d) 372 (C. C. A. 8th, 1931), *cert. den.*, 284 U. S. 676 (1931); Midland Valley R. R., 19 B. T. A. 423 (1930), *aff'd*, 57 F. (2d) 1042 (C. C. A. 10th, 1932); Kansas City Southern Ry., 22 B. T. A. 949 (1931), *rev'd* on other issues, 75 F. (2d) 786 (C. C. A. 8th, 1935); Kauai Ry., Ltd., 13 B. T. A. 686 (1928).

[51] Detroit Edison Co., 45 B. T. A. 358 (1941), *aff'd*, C. C. A. 6th, Nov. 30, 1942, 1942 CCH TAX SERV. par. 9778; Tampa Electric Co., 12 B. T. A. 1002 (1928); El Paso Electric Ry., 10 B. T. A. 79 (1928); Wisconsin Hydro-Electric Co., 10 B. T. A. 933 (1928); Rio Electric Co., 9 B. T. A. 1332 (1928); Liberty Light & Power Co., 4 B. T. A. 155 (1926), *Acq.* VI-1 C. B. 4.

[52] Arkansas Compress Co., 8 B. T. A. 155 (1927); Holton & Co., 10 B. T. A. 1317 (1928), *Acq.* VII-2 C. B. 18; G. C. M. 16952, 1937-1 C. B. 133. *Contra:* A. R. R. 3513, II-2 C. B. 83 (1923).

[53] Texas and Pacific Ry. v. U. S., 286 U. S. 285 (1932); Continental Tie and Lumber Co. v. U. S., 286 U. S. 290 (1932); Helvering v. Claiborne-Annapolis Ferry Co., 93 F. (2d) 875 (C. C. A. 4th, 1938); Lykes Bros. Steamship Co., Inc., 42 B. T. A. 1395 (1940); *cf.* Boston Elevated Ry., 131 F. (2d) 161 (C. C. A. 1st, 1942).

It is interesting to note that if the contractor exercises his option in the EPF contract to purchase the property at cost less depreciation, there is, in effect, a reimbursement to the extent of depreciation sustained, which is a current operating expense.

[54] See, *e.g.*, Baboquivari Cattle Co., 47 B. T. A. 129 (1942), holding that AAA soil conservation payments, reimbursing a ranch owner for physical improvements to the property, should be included in gross income. Section 19.124-6 is cited in this opinion in support of the result.

If there is a trend in this direction, the Treasury rule may be justifiable in that it encourages the taxpayer to apply promptly for amortization benefits which might otherwise be forfeited by delay.

Perhaps a further reason for the Treasury's insistence that reimbursement for facilities should be treated as income was the possibility that the taxpayer might also be entitled to depreciation (assuming, of course, that the taxpayer retains title). This possibility was foreclosed in the EPF contract by a provision under which, if the payments are held not to be includible in gross income, the taxpayer agrees to exclude the amount of the payments from the basis of the facilities and from the computation of invested capital for excess profits tax purposes. In the absence of a specific agreement, however, the taxpayer contended for the allowance of depreciation, despite the reimbursement.[55] If the transaction was treated as a gift of the facilities, the taxpayer invoked Section 113(a)(2) which provides that the donee shall take the donor's basis for the property. Or, if it was regarded as a contribution to capital, Section 113(a)(8) provides for the use of the transferor's basis. The Regulations under this section do not limit its application to capital contributions of shareholders but refer to contributions by "any person."[56] The Government, on the other hand, argued that this result should be avoided by the application of Section 113(b)(1)(A) requiring an adjustment to basis for "receipts . . . properly chargeable to capital account." This dispute has now been resolved by the Supreme Court in the *Detroit Edison* case,[56a] denying the taxpayer's claim to a depreciation allowance on rural electric facilities for which it was reimbursed by its customers.

III. Government Ownership

By far the largest share of wartime plant expansion has been made directly for the account of the Government. Within this category are the "cost-plus-fixed-fee" type of construction contracts, the "no profit" contract (usually for equipment installations) and the Defense Plant Corporation contracts. In all of these contracts, the contractor is described as an "agent" of the United States, and purchases are made in the name of the United States. Ownership of the facilities is stated to be in the United States at all times.

Despite the characterization of the contract as an agency, it is doubtful whether such a relationship actually exists. In *Alabama v. King and Boozer*,[57] the Supreme Court held that a cost-plus-fixed-fee contractor was an independent contractor, and, as such, was subject to a state sales tax on the purchase of lumber for a government construction project. In this instance, the contractor purchased the lumber with his own funds and for his own account (subject to approval of the purchase order by a government contracting officer) and was reimbursed by the Government upon sub-

[55] The Detroit Edison Co. v. Commissioner, No. 675, May 3, 1943.

[56] U. S. TREAS. REG. 103, §19.113(a)(8)-1.

[56a] Arundel-Brooks Concrete Corp., 129 F. (2d) 762 (C. C. A. 4th, 1942), holding that the entire cost, including the contribution, may be depreciated by the donee.

[57] 314 U. S. 1 (1941).

mission of the invoices. While the form of contract has been changed since this decision, so that purchases are no longer made in this manner, the substance of the relationship has not been altered. For this reason, the Treasury Department is inclined to regard government contractors as independent contractors.

Furthermore, the Treasury regards the transaction as a sale of assets used in the trade or business, rather than a sale of capital assets. Under this interpretation, the amounts received from the Government should be treated as ordinary income, and the cost of performing the contract should be taken as a deduction. Again, the Treasury's interpretation seems rather strained, since most war contractors are not in the construction business, and do not themselves construct the facilities. If they are not in fact agents of the Government, they seem rather to be brokers or intermediaries in a casual sale of capital assets. As a matter of fact, the Commissioner ruled, as late as 1940, that a taxpayer realized no income as a result of the receipt of funds from a foreign government to construct facilities which became the property of a corporation wholly owned by the foreign government.[58]

However, it is frequently to the taxpayer's advantage to treat the transaction in the manner favored by the Treasury Department. Some items of overhead which are deductible for tax purposes are not allowable as costs in performing a government contract. If, as a result of such disallowed costs, the taxpayer sustains a loss on the job, it is obviously preferable to treat it as an ordinary loss, not subject to capital loss limitations.

There has also been considerable uncertainty regarding the proper treatment for tax purposes of agreements for operating government plants after construction. The agreements are usually designated leases and provide for rental payments which are ordinarily equivalent to the normal physical depreciation of the property. In many cases, however, the lessee has an option to purchase the property, and the rentals paid are credited upon the purchase price. There may also be a provision for a "cut-off" of the rent when the payments equal the cost of construction. Moreover, the rental payments may be set at a high figure so that payment of the entire cost is reached within a five- or seven-year lease term. In view of these factors, some of the so-called leases closely resemble sales on installment. The question then arises whether the periodic payments are deductible or whether the taxpayer has a capital investment which should be depreciated or amortized. There are several cases on somewhat similar facts which lend support to the conclusion that many such leases are in reality sales.[59] Nevertheless, it is understood that the Commissioner has entered into closing agreements in several instances that the annual payments will be allowed as current deductions, provided the taxpayer agrees to return as income the excess of the market value of the property over the option price when the option is exercised.[60] The

[58] I. T. 3409, 1940-2 C. B. 38. See, also, I. T. 3349, 1940-1 C. B. 11.

[59] Watson v. Comm'r., 62 F. (2d) 35 (C. C. A. 9th, 1932); Rankin v. Comm'r., 60 F. (2d) 76 (C. C. A. 6th, 1932); Jefferson Gas Coal Co. v. Comm'r., 52 F. (2d) 120 (C. C. A. 3d, 1931); Goldfields of America, Ltd., 44 B. T. A. 200 (1941); Helser Machine and Marine Works, 39 B. T. A. 644 (1939); Robert A. Taft, 27 B. T. A. 808 (1933); Alexander W. Smith, Jr., 20 B. T. A. 27 (1930).

[60] These rulings are unpublished.

Commissioner has further ruled that no income is realized by a taxpayer operating a plant owned by a foreign government without payment of any rental.[61]

Recently, both the War and Navy Departments have denied applications for Necessity Certificates covering the cost of acquiring facilities from Defense Plant Corporation through the exercise of purchase options in lease agreements. The basis for the denial of such applications is that once the facilities are installed at Government risk and expense, it is not necessary to national defense to transfer them to private ownership. From a fiscal point of view, this result is unfortunate. Furthermore, the reasoning appears unsound if the option is exercised within a reasonable time after completion of the facilities. In such a case, the Government occupies a position not essentially different from that of any building contractor who constructs facilities for the taxpayer. A different case is presented if the option is not exercised until the end of lease term, or when it becomes obvious that the end of the war is close at hand.

CONCLUSION

It is probably optimistic to suppose that the tax problems of wartime plant expansion will result in less litigation after this war than the last. Nevertheless, the Tax Certification Sections and the Treasury Department have made valiant efforts to prevent repetition of some of the errors of World War expansions and to reduce the area of future disputes. In general, the amortization provisions have been liberally construed and fairly administered. In many instances, the administrative agencies have leaned backwards to avoid hardship and inequitable results. Despite minor differences of opinion, some of which have been reviewed herein—perhaps with too much emphasis—taxpayers have every reason to be grateful for the earnest consideration and assistance they have received in the War, Navy and Treasury Departments in connection with their expansion programs.

[61] I. T. 3407, 1940-2 C. B. 36.

THE TAX TREATMENT OF FOREIGN WAR LOSSES

Arthur H. Kent*

The Revenue Act of 1942, from the point of view of revenue yield, is the greatest tax law in our national history. But it is also preeminent in point of the number of important provisions it contains which were motivated by considerations of equity and the prevention of gross hardship to taxpayers.[1] Some of these, such as the net operating loss and unused excess profits tax credit carry-backs, have the characteristics of basic reforms. It is to be hoped that they will become permanent features of the income tax structure. Section 127 of the Internal Revenue Code,[2] added by Section 156 of the 1942 Act, to which this article is devoted, can hardly claim the distinction of being in itself a basic reform, since it was framed to meet an emergency situation which may not recur. Nevertheless, the fairness and practicality of its approach may afford a helpful precedent in the equitable solution of other unforeseeable problems of the future. Also, the new war loss provisions are sufficiently important in themselves, because of the magnitude of the interests affcted, to warrant some comment, although a complete analysis of the details of the section's application would transcend the space limitations on the present article. Such a comment is not out of place in a symposium devoted to the excess profits tax, for not only is the section, like the tax, a response to the war emergency but also the extremely high rate of tax imposed on excess profits by the 1942 Act was one

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[1] Such as the restoration of the privilege of filing consolidated returns for purposes of the normal tax and surtax as well as the excess profits tax, and the numerous remedial amendments to the excess profits tax (subchapter E of chapter 2 of the Code), including the complete revision of §722, relating to excess profits tax relief.

[2] In addition to §127, the following amendments to the Code have important consequences in the treatment of foreign war losses in many cases: §141, relating to consolidated returns of corporations, particularly the last sentence of §141(b); §122(b), relating to the two-year carry-back of net operating losses; §710(c)(3), relating to the two-year carry-back of unused excess profits credit; §131(a), eliminating the requirement of election of the foreign tax credit; §23(k), eliminating the requirements of ascertainment of worthlessness and charge-off of bad debts; §117(j), relating to gains and losses from involuntary conversion; and §322(b)(5), creating a special seven-year period of limitation on claims for refund based on bad debt and worthless security losses.

of the major factors which made some form of special treatment of these losses imperative, unless gross injustice were to be done.

The text of the provisions of Section 127[3] is quite complicated. But the major principles which underlie it are not. These major principles may be summarized as follows:

(1) The classification of losses falling into the category of foreign war losses should not depend upon the technical form of the foreign property or investment, and such losses, when sustained, should not be subject to the arbitrary limitations imposed upon the deduction of capital losses.

(2) Practical and reasonably definite and certain rules should be provided in the statute for determining in what taxable year such losses shall be deemed to have been sustained for income tax purposes. Otherwise, interminable confusion and much long-drawn out and wasteful litigation would be certain.

(3) Since such practical and definite rules must of necessity be somewhat arbitrary, appropriate provisions should be made to prevent these rules from working gross hardship in certain situations.[4]

(4) Since it is possible that some part of these losses may be recouped by taxpayers in one way or another after the war, specific provision should be made to govern the treatment of such recoupment as income in a manner equitable to both the Government and the taxpayers.

(5) Recognition of stock and security losses should be provided in a limited class of cases where the loss of value is not complete, but where the corporation issuing such stock or securities has sustained war losses which are probably irreparable in character and catastrophic in extent.

It is fair to say that the provisions of Section 127, which were recommended by the legislative experts of the Treasury, represent an intelligent and bona fide effort to solve the complex problems presented in accordance with these major principles and objectives. Also, the Treasury Regulations,[5] promulgated under Section 127, are deserving of praise, in the main, as a fair interpretation and application of the new statutory provisions. The factual situations involved in foreign war loss cases, how-

[3] Section 127 itself was made applicable to taxable years beginning after Dec. 31, 1940, but no war loss could be sustained prior to Dec. 7, 1941. Revenue Act of 1942, §156(b), INT. REV. CODE §127(a)(1). The section occupies nearly four pages in the Code and contains six subsections. Subsection (a) delimits the cases in which a war loss is deemed to have been sustained and the rules for determining in what taxable year or years such loss may be treated as having been sustained; (b) relates to the determination of the amount of loss on property deemed to be seized or destroyed under subsection (a); (c) relates to the inclusion of recoveries in gross income, *i.e.*, contains the rules governing the tax consequences of recoupment of war losses; (d) contains the rules relating to the basis of recovered property; (e) contains the new concept of deduction of losses attributable to partial worthlessness of investments in property deemed to be destroyed or seized; and (f) contains a provision authorizing regulations to determine when and to what extent the deduction of war losses results in a tax benefit.

[4] The Code provisions relating to carry-back and carry-forward of net operating losses and unused excess profits credits, the special rule in §141(b) relating to the carry-over into a consolidated return year of an operating net loss of an affiliate in a prior non-consolidated year, and the elimination of the requirement of election of the foreign tax credit, retroactive to 1941 taxable years, operate to prevent or minimize such hardships, and were motivated in part or in whole by these equitable considerations.

[5] Reg. 103, §19.127.

ever, are so well nigh infinite in variety and some of them so complex in their ramifications that it is inevitable that the results in some of them may not be wholly satisfactory to all the parties in interest. It may be that experience in administration will establish the necessity of some amendment of Section 127 or modification of a few of the rules which it contains.

Section 127 came into the revenue bill of 1942 in the Senate, being added by the Senate Finance Committee as an amendment, Section 156, to the House bill. The amendment was quickly accepted, with certain meritorious substantive and clarifying amendments, by the conference committee. The Finance Committee Report stated that the section provided "practical rules for the treatment of property destroyed or seized in the course of military or naval operations during the war, and of property located in enemy countries or in areas which come under the control of the enemy." It also stated that two principal problems are likely to face the taxpayer, the first being to determine when actual destruction or seizure of property occurred in cases in which hostilities in the area of its situs prevent actual determination of the exact date of such destruction or seizure, and the second is to know what facts determine the loss in case the property is located in an enemy-controlled area.

It seems impossible either to deny or to exaggerate the seriousness of both of these problems. The difficulty of obtaining requisite proof of events transpiring in war-torn areas, to say nothing of the exact time of their occurrence, would have been sufficiently great under the most favorable conditions. The problem became insuperable under the conditions of modern warfare, in which the blockade on information from territories invaded and overrun by the enemy was virtually complete. How could American taxpayers with property in Manila or in Malaya determine the fate of such property in point of fact, or the date of its destruction or seizure, if destroyed or seized in fact it was? The burden for calendar-year taxpayers was further aggravated by the fact that the enemy was engaged in the process of overrunning areas, in which important property holdings and investments were located or centralized, at the very end of the calendar year 1941. Yet the structure of the revenue laws prior to Section 127, as they related to the allowance of a deduction for losses, assumed the possibility of exact proof both of the fact of loss and the time when it occurred. Finally, the taxpayer's rights in such cases were endangered by a short statute of limitations of three years on claims for refund. No one knew how long the war might last, when the blockade on channels of information would be removed, or whether the requisite proof would still be available when the war was over.

In addition to these uncertainties of fact in cases where there was actual destruction or seizure of property by the enemy, there was grave legal uncertainty as to the status for tax purposes of property which was already under the effective jurisdiction and control of enemy countries upon the dates of the declarations of war after Pearl Harbor or which subsequently came under such jurisdiction and control

by virtue of enemy occupation of territory. Was actual seizure of such property, or at least the promulgation of a decree by the enemy government authorizing seizure, necessary as a definitive event to establish a loss for tax purposes, or was the mere fact of jurisdiction and control by a nation now become an enemy sufficient? No one short of the Supreme Court of the United States could answer these questions with certainty, and an answer from that tribunal could not be expected for several years. A repetition of the long period of litigation and confusion which enshrouded the administration of the revenue laws in related situations during and after World War I seemed probable, a prospect that could not easily be tolerated. True, the Supreme Court had finally held nearly a decade after that war, in *United States v. White Dental Mfg. Co.*,[6] that a taxpayer was entitled to a loss deduction in 1918 on account of property which it was stipulated was actually seized by German authorities in that year, and that the possibility of recovery in kind or of reimbursement after the war was too speculative to postpone realization of the loss. But subsequent to that decision the Chief Counsel of the Bureau, in a belated effort to throw these losses into a year of lower rates, ruled that losses in Germany were sustained in 1917 for the reason that the promulgation of a decree in that year authorizing administrative seizure or sequestration *ipso facto* constituted a constructive seizure of all American properties in Germany.[7]

What assurance could there be, in the conditions of 1941, that a realistically-minded court would not hold that prior control over American property by a totalitarian government plus the fact of a declaration of war was sufficient to constitute a constructive seizure? Certainly such a holding would have done no violence to the realities of the situation. No one could assert seriously, for instance, that the ownership of a factory by an American corporation in Germany or Japan retained any value after the declaration of war in December, 1941.

It is apparent that those who drafted the provisions of Section 127 and the Congress in adopting it took such a realistic view of the situation. Under Section 127(a)(2), property which is within any country at war with the United States or within an area under the control of any such country on the date war was declared by the United States is deemed to have been destroyed or seized on the date of such declaration. This presumption of destruction or seizure is no *prima facie* presumption; that it is conclusive is clear from the committee reports and the Treasury regulations. Consequently, mere proof of the presence of such property in an enemy country or an enemy-controlled area at the designated date is ordinarily sufficient to establish a loss. Under Section 127(a)(1), property situated in an area which comes under control of an enemy country after the date of the declaration of war therewith is likewise conclusively deemed to have been seized or destroyed on the date such control is established.

This statutory rule that property under the control of an enemy country shall

[6] 274 U. S. 398 (1927).

[7] G.C.M. 10630, XI-2CB, 97.

be deemed to have been seized or destroyed on the date of the declaration of war or on the subsequent date when such control is established is not limited in its application to real property or tangible personal property having a physical situs in enemy-controlled territory. It applies also under Section 127(a)(3) to numerous types of intangible interests, such as stock, bonds, and the like, which are referable to, and derive their value from, such destroyed or seized property. Suppose, for instance, that a domestic corporation owns stock and bonds of a Dutch corporation all of whose assets were situated in Holland. Since all of such assets are deemed to have been destroyed or seized on the date war was declared against Germany, the stock and bonds in question are likewise considered to have been destroyed or sized, and the loss sustained on that account is to be treated as a loss due to destruction or seizure. It is further specifically provided that Sections 23(g)(2) and 23(k)(2) shall not apply to any interest deemed to have been destroyed or seized under Section 127(a)(3). In other words, the deduction of such security losses is freed from the capital loss limitations imposed by those sections.

It should be noted, however, that Section 127(a)(3) is limited in its application[8] to cases in which the interest would have become worthless if the property to which such interest relates had been destroyed. Consequently, if in the above illustration the Dutch corporation had property in England or the United States or in other territory not under enemy control, which would mean that its securities still had some residuum of value, Section 127(a)(3) would not apply, and no war loss deduction would be allowed on account of such interest unless the case were one in which the conditions of Section 127(e) could be satisfied. Except for this limitation, however, the section is very broad in its application, and applies equally to land, interests in real property, and to tangible and intangible personal property interests.[9]

[8] There is one limited exception to this rule. Section 127(a)(3) provides that a taxpayer which owns 100% (excluding qualifying shares) of each class of stock of a corporation may elect, under Treasury regulations, to determine the worthlessness of its interest, described in such section, in or with respect to the property of such corporation, without regard to the amount of the property of such corporation which would be excluded in determining the adjusted basis of all the assets of the corporation for the purposes of subsection (e), but such amount shall be treated under subsection (b)(1) as a recovery by the taxpayer in the taxable year with respect to such interest.

The operation of this exception may be illustrated by an example. Corporation *X*, a domestic corporation, owned all the stock of corporation *Y*, having an adjusted basis of $1,000,000, *Y* being engaged in the extraction and refining of petroleum in Sumatra. All of the assets of *Y* consisted of land, leases, wells, pipe lines, and refineries in Sumatra, except that *Y* had bank accounts in New York and London banks aggregating $100,000. The properties of *Y* in Sumatra were intact on January 1, 1942, but were overrun early in that year by Japanese forces invading Sumatra, and a portion of the plant was destroyed by scorched-earth operations just prior to the invasion. *X* has a deductible loss on its 1942 return of $1,000,000, but must treat the bank accounts of $100,000 as a recovery in 1942, resulting in a net war loss deduction of $900,000.

The effect of this exception is to carve a small group of cases in which relief would otherwise have to be sought under §127(e) out of the latter section and to treat them as cases of total worthlessness under §127(a)(3), with an offset of the value of the assets excluded in the adjusted basis determination prescribed by §127(e). The principal practical result is to obviate the necessity of liquidation of the subsidiary which is a condition to claiming the benefits of §127(e).

[9] The Conference Report, Statement of the Managers on the Part of the House, at p. 48, states specifically that, for the purposes of §127(a)(3), land seized in the course of military or naval operations or within an area under enemy control is treated, for the purposes of determining whether the stock

It should not be inferred from the foregoing discussion, however, that war losses referable to the ownership of corporate stock, bonds, or other obligations must in all cases be established, if at all, under Sections 127(a)(3) or 127(e). Such is not the case, for in many instances Section 127(a)(2) will apply. A typical case to illustrate is one in which a taxpayer owned a minority stock interest or bonds of a corporation incorporated under the laws of Germany, which had a factory in the Reich on December 10, 1941, but which also had substantial bank accounts in Switzerland and perhaps accounts receivable owing by solvent debtors in countries not at war with the United States or even in the United States itself. Section 127(a)(3) would not necessarily apply to such a case, since the destruction of the properties in Germany would not of necessity destroy completely the value of the stock or bonds. The taxpayer cannot satisfy the conditions to relief under Section 127(e). Nevertheless, such a taxpayer will in all probability be entitled to claim a loss on account of this investment under Section 127(a)(2).[10] The basis of such application is the fact that the corporation is a German corporation; hence the Nazi government has the power to make an effective seizure of the stock or the bonds of its corporate creature owned by an American taxpayer. Such would not be the case if the corporation in question were one incorporated under the laws of Holland, where only a portion of the corporate properties had come under effective enemy control.[11]

The problem of timing of war losses with respect to their assignment to the correct taxable year is simple in those cases in which the loss is governed by Section 127(a)(2), as well as in those cases in which a loss claimed under Section 127(a)(3) represents an interest referable to property deemed to be seized or destroyed, where the property in question is so considered as seized or destroyed under Section 127(a)(2). By the fiat of the statute, such losses must be deducted, if at all, in the taxpayers return for the taxable year in which war was declared against the country in which the property was situated or which had control of the property upon the date of such declaration. This statutory rule may seem arbitrary, but it does have the great merit of definiteness and certainty. Moreover, it can be criticised as arbitrary only upon the questionable assumption that the rule adopted is not the same as that which the courts would have finally declared under the pre-existing law.

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or bonds of the corporation owning such land have become worthless, as having been destroyed, even though land may ordinarily be regarded as indestructible.

[10] See Reg. 103, §19.127(a)-3, for a clear recognition of this principle. The vital issue is whether the enemy country may legally divest the taxpayer of its right to such intangible property in such manner that all other jurisdictions having control of any of the obligations and assets from which such intangible property derives its value would not recognize the taxpayer as having any interest in such obligations and assets. The regulation states: "Ordinarily, if the right of the taxpayer to the intangible property exists by reason of the law and authority of the enemy country, section 127(a)(2) applies to such intangible property." This would be true ordinarily in the case of stock or bonds or debts of a corporation incorporated under the laws of an enemy country and owned by an American taxpayer. On this sound interpretation, the regulation also specifically recognizes that all public bonds of a country at war with the United States are considered to be within the provisions of §127(a)(2).

[11] See Reg. 103, §19.127(a)-3.

It is only in those cases to which Section 127(a)(1) is either applicable directly, or is applicable indirectly through Section 127(a)(3), that the special rules contained in Section 127(a)(1) may be resorted to. These are all cases in which the taxpayer's property (or investment) was situated in territory which was under control of the United States or a friendly power on the date war was declared against an enemy country, but which was subsequently invaded and overrun by such enemy power. The Far East (Philippines, Hongkong, Malaya, Burma, Singapore, Dutch East Indies, South Pacific Islands, etc.) contains the territories to which the special rules relative to the timing of losses have their chief application. Even here the basic rule applied is that the loss shall be assigned to the taxable year of the taxpayer in which the enemy established its control over the territory in which the taxpayer's property (or investment) was situated.

It is clear that many of these areas, such as Java, Burma, and probably Sumatra, were not invaded in 1941, although danger of invasion was apparent and air raids by the Japanese may have occurred, but remained under friendly control until some time after the beginning of 1942. The war losses in such territories are clearly 1942 losses, at least for calendar-year taxpayers. Likewise, certain islands such as Guam had been completely conquered by Japan before January 1, 1942. Losses there would be clearly assignable to 1941. It may be there are some instances where particular properties in the former territories were destroyed or seriously damaged by Japanese bombs or scorched-earth operations in December, 1941. Such losses might, of course, be taken in the returns for 1941 if the requisite proof is available. There were certain areas, however, such as Malaya, Hongkong, and several of the major islands of the Philippines, where invasion was actively under way at the end of 1941 but was not completed until some time early in the following year. About all that can be said is that on December 7, 1941, the property was in territory then under American or friendly control and that not later than some date in 1942 such control had definitely passed to the enemy. The exact date on which control may be said to have shifted to enemy hands cannot be ascertained.

In cases of this type, Subsection 127(a)(1) vests in the taxpayer a limited right of election, the manner of exercise of which may determine whether the loss is deducted in the 1941 or 1942 return. If thrown into 1941, an amended return and a claim for refund would usually be necessary. The subsection does this by providing that the taxpayer may choose as the date of destruction or seizure any date which falls between the latest date, as established to the satisfaction of the Commissioner, on which the area wherein the property was situated was under the control of a country not at war with the United States and the earliest date, as so established, on which such area was under the control of an enemy country. If the earlier date falls in 1941 and the later date in 1942, the taxpayer's election applies.

It is obvious, however, from the language of the section that the Commissioner's determination as to the dates of loss and acquisition of control will carry great

weight. Furthermore, the importance of the election will depend to a considerable extent upon the manner in which the statutory term "area" is interpreted in the administrative application of the statute. Too strict and rigid interpretation would virtually destroy the practical value and flexibility of the statutory formula. The regulations indicate a reasonably liberal and practical interpretation will be adopted. Thus, the island of Luzon is specifically recognized as one theatre of military operations and therefore presumably one area, as to which complete American control ceased in December, 1941, and complete Japanese control was not established until the fall of Corregidor in May, 1942. The regulations indicate that the entire Philippine group may be treated in like manner. It may reasonably be expected that the Malayan peninsula will be similarly regarded as one area, although the inclusion of Singapore Island in that area may present a more doubtful question.

Section 127 thus greatly simplifies the administration for tax purposes of foreign war losses by treating property and interests referable to property situated in an enemy country or enemy-controlled territory on the date of the declaration of war as destroyed or seized on that date, and by treating property subsequently coming into enemy control as seized or destroyed at the time such control is established, without regard to whether seizure or destruction in fact is proved. But this method of treatment has even more important substantive tax consequences by reason of its effect upon the classification of these losses. Losses due to destruction or seizure are classified as casualty losses.[12] As such, they either come into the category or have the substantial effect of ordinary losses and are thereby freed in all cases, without regard to the technical form of the taxpayer's foreign property or investment, from capital loss limitations.[13] Hence, such war losses may be applied against ordinary business income for excess profits tax as well as normal and surtax purposes, and, to the extent that they arise out of the taxpayer's trade or business,[14] they will be taken into account in the computation of net operating loss for the purposes of both the new carry-back and the older carry-over provided by Section 122 of the Code.

[12] Reg. 103, §19.127(b). Section 19.127(a) properly interprets the term "military or naval operations" in §127(a)(1) as intended to cover all actions incident to belligerent activities, whether in furtherance of or opposition thereto, and hence as including operations in execution of a scorched-earth policy or rendering a position under threat of attack or other danger more secure or less desirable to the attacker.

[13] In the interests of complete accuracy, it should be noted that, for the taxable years beginning after Dec. 31, 1941, war losses, which are by statutory fiat treated as due to destruction or seizure, are assimilated into the category of losses from involuntary conversion subject to the provisions of §117(j) of the Code. In most cases this special classification will make no great difference, since all that it means is that such losses must first be offset against gains in the §117(j) category, *i.e.*, gains from involuntary conversion of capital assets held for more than six months or of property used in a trade or business, and gains from the sale or exchange of property used in a trade or business. Any excess of losses over gains in the new category will continue to enjoy the status of ordinary losses for tax purposes; only a net gain would be subject to capital gain tax limitations. In taxable years beginning prior to Jan. 1, 1942, war losses are treated as ordinary losses without even the foregoing technical limitation.

[14] This is of practical consequence only to individuals, since all losses of corporations are deemed to arise out of the corporate business and hence will enter into the computation of net operating loss unless excluded by reason of classification as capital losses and the limitations incident thereto. Some individuals may get a lesser tax benefit than corporations out of war losses because of the limitations in §122, but their situation in this respect is not worsened by §127.

The foregoing is the most important substantive liberalization made by Section 127. Under the pre-existing law, it is clear that losses due to stock and bond investments becoming worthless by reason of the seizure or destruction of underlying assets would have been subject to capital loss limitations.[15] As such, they could not have been deducted for excess profits tax purposes nor would they have been eligible to the benefits of Section 122.[16] Even the classification of losses due to expropriation or sequestration by an Axis government of stock or bonds issued by a corporation incorporated under its laws and owned by American nationals was a matter of serious doubt.[17] Only in the case of loss of tangible property or of intangibles, other than corporate stocks and securities, directly owned by American taxpayers, by reason of action by enemy governments, could it have been confidently asserted that the loss would have constituted an ordinary loss prior to the enactment of Section 127.

But for the adoption of certain other provisions in the Revenue Act of 1942 which correlate very well with Section 127, the more or less arbitrary rules governing the timing of war losses might have produced serious hardship and inequity in certain cases. These other provisions, however, tend substantially to prevent or ameliorate such hardships. The most important of these provisions are the new two-year carry-backs of net operating loss and unused excess profits credit. There are at least a few cases in which American corporations operating directly or through subsidiaries in Sumatra, Java, Borneo, or elsewhere in the Far East lost all their income-producing properties as the result of the Japanese conquest of those areas. Some of these corporations had very substantial taxable incomes for the calendar year 1941, but had little or no income or substantial losses for 1942 and in all probability will have no income for several years thereafter. The formula contained in Section 127(a)(1) would almost certainly fix their losses for tax purposes in 1942. Without the carry-back, a serious hardship would be inflicted in such cases. The new carry-backs of net operating loss and unused excess profits credit to 1941 taxable years will provide substantial relief.

One other special situation arose out of the fact that consolidated returns were allowed only for excess profits tax purposes for taxable years beginning prior to January 1, 1942. In some cases, the foreign properties or investments of affiliated groups were concentrated in the ownership of only one or two affiliates in a group. If heavy war losses under Section 127 were sustained in a 1941 taxable year on account of such properties and investments, the group could get an excess profits tax benefit, if its income were sufficiently large, for all of such losses, but the losses

[15] INT. REV. CODE, §§23(g)(2) and 23(k)(2). It has been pointed out that these provisions are specifically made inapplicable to investment losses under §127. See §127(a)(3).

[16] The situation would have been still more serious for taxable years beginning after Dec. 31, 1941, by virtue of the new provision in §117(d) of the Code limiting the deduction of corporate capital losses to the amount of corporate capital gains, despite the five-year capital loss carry-over provided by §117(e).

[17] But see Emil Stern (1926), 5 B.T.A. 89. *Cf.* Helvering v. Wm. Flaccus Oak Leather Co. 313 U. S. 247 (1941).

could be applied for normal tax and surtax purposes only against income of the particular corporate entity or entities in the group sustaining such losses. The result of such application might be a large net operating loss to the particular affiliate or affiliates.

In the event a consolidated return were filed by the group for the 1942 taxable year, the rule under the prior law and regulations was that the particular affiliate could carry forward such net operating loss for 1941 into 1942 or 1943 only in an amount not in excess of its net income for such year or years. Section 141(b) of the Code, as amended by Section 159(a) of the 1942 Act, prevents this harsh result by the following specific provision:[18]

Such regulations shall prescribe the amount of the net operating loss deduction of each member of the group which is attributable to a deduction allowed for a taxable year beginning in 1941 on account of property considered as destroyed or seized under Section 127 (relating to war losses), and the allowance of the amount so prescribed as a deduction in computing the net income of the group shall not be limited by the amount of the net income of such member.

It is unnecessary to state that, where such 1941 war losses have been applied in a consolidated excess profits tax return for a 1941 taxable year to reduce consolidated excess profits net income, the above special provision in Section 142(b) will not operate to allow the group or the particular affiliate a duplicate consolidated excess profits tax benefit in 1942. The special provision relates only to the net operating loss, not the unused excess profits credit, and the carry-over in such a case would be limited in its application to consolidated normal tax and surtax net income. If the group, however, showed a consolidated excess profits income for 1941 which was less than its credit by reason of the deduction of war losses, the unused consolidated excess profits credit could be carried forward to reduce consolidated excess profits net income for the subsequent year.[19]

Section 127 has no application in determining whether war losses are to be attributed to sources within or without the United States. That question is left to be determined under Section 119 of the Code. In most cases, at least, such losses would probably be allocable to sources outside the United States. The result is that in the application of the foreign tax credit provided by Section 131, such losses would be allocated against foreign income and would reduce *pro tanto* the numerator of the fraction used in the computation of the credit. In cases in which Section 127 operated to throw large war losses into 1941, the effect might be greatly to reduce or even to eliminate the credit for foreign taxes for that year to which the taxpayer would have otherwise been entitled. Many taxpayers had filed their 1941 returns and elected the credit under Section 131, thereby precluding the use of such foreign

[18] See Reg. 104, §23.31(d)(4), which gives administrative effect to this legislative mandate. Under this regulation the portions of the net operating loss attributed to war losses is the excess of the net operating loss for such year over the amount of any net operating loss computed without regard to war losses. This is both the simplest rule to administer and the most liberal to the taxpayer.

[19] See Reg. 110, §33.31(a)(33).

taxes as deductions, before the enactment of the 1942 Act and before the statutory changes relative to war losses were known. Such taxpayers might have been caught in a trap because election of the credit in the return was formerly irrevocable under the statute. The possibility of any such hardship or inequity was prevented, however, by the amendment made to Section 131(a) eliminating the irrevocable election retroactive to taxable years beginning after December 31, 1940.

The amendment to Section 23(k) eliminating the requirements of ascertainment and charge-off in the case of bad debts and thereby making the rule the same for debts as for stocks, *viz.*, the year of worthlessness in fact, will apply to debts, including corporate securities, which might otherwise be war losses under Section 121, in one important respect. Since this amendment is retroactive to taxable years beginning after December 31, 1938, the objective test of worthlessness it applies may operate to take some debts out of Section 127 altogether. This is true where such debts had become uncollectible and worthless in fact prior to December 7, 1941, but had not been ascertained to be worthless and charged off on such date, since Section 127 does not apply if a deductible loss has been sustained prior to that date.

The amendment to Section 322(b)(5) providing a special seven-year statute on claims for refund based on bad debt and worthless security items should be definitely beneficial in safeguarding rights of taxpayers having investment interests in enemy countries. There is nothing in Section 127 which warrants an inference that Section 322(b)(5) is not intended to apply to such items merely because they constitute war losses. Section 127(a)(3) only makes inapplicable Sections 23(g)(2) and 23(k)(2), the provisions imposing capital loss limitations, to investment losses which are also war losses.

The basic yardstick for determining the amount of loss sustained with respect to property deemed to be destroyed or seized under Section 127 is, of course, the adjusted basis of such property.[20] It would have been difficult to justify any other rule as a matter of policy, and the adjusted basis rule is also capable of convenient administration. There would be no more reason for allowing a deduction for unrealized (and untaxed) appreciation in the value of property in Germany than in the case of a building in the United States destroyed by flood or tornado. Section 127(b)(1), however, requires the amount of loss to be determined with regard to any recoveries with respect thereto in the taxable year but without regard to any possibility of recovering such property or interest or compensation therefor in the taxable year or subsequently, other than insurance or similar indemnity. This is a

[20] It should be noted that §127 does not require any allocation of loss between depreciation in value prior to the date of the declaration of war and the loss of remaining value after that date. If no deductible loss has been realized on account of the property prior to Dec. 7, 1941, it may become a war loss under §127 and, if so, will support a deduction in the full amount of its adjusted basis. It is fortunate Congress adhered to this policy, since any rule which was based upon an effort to make a refined determination of the extent to which the outbreak of war was the proximate cause of the loss would have been administratively impossible. Implicit in such a rule would have been the necessity of valuing each item of property as of Dec. 7, 1941. No argument is necessary to show that such a requirement would have largely nullified the benefits of §127, and would have been of doubtful benefit

fair rule and reflects the realistic doctrine of the *White Dental Manufacturing Company* decision.[21]

Section 127(b)(2) introduces a somewhat different, though sensible idea. It permits the taxpayer to decrease the amount of its war loss for deduction purposes by all obligations or liabilities of the taxpayer with respect to such property or interest discharged or satisfied out of the property or interest upon its destruction or seizure, if the Commissioner is satisfied that such liabilities are so discharged or satisfied that the taxpayer is unable to determine whether there is such discharge or satisfaction in fact. The taxpayer's choice or election must, in order to be effective, be made within such time and in such manner as may be prescribed by Treasury regulations. This provision permits a banking corporation, for instance, which has a branch in an enemy country, to offset deposit liabilities against deposit assets in computing the loss to be deducted in its return. It also allows a taxpayer to deduct from the basis of property in an enemy area, which is subject to a mortgage or lien in favor of an enemy national, the amount of such encumbrance, thereby deducting the loss on a net basis. The probability is, in such cases, that the enemy government will use the assets under its control, so far as necessary, to pay the claims of its own nationals.[22]

The provision is correlated, however, with Section 127(c), relating to inclusion of recoveries in gross income, so as to protect a taxpayer who fails to claim a full deduction on a gross basis in reliance upon an assumption, proved subsequently to be erroneous, that the offset liabilities will be satisfied or discharged out of the property, and who is subsequently held liable to discharge such liabilities out of other property. Such protection is afforded by a provision in Section 127(c)(2) that the amount of such obligations and liabilities erroneously treated as discharged or satisfied under Subsection (b) shall be considered for the purposes of Section 127 as a deduction which did not result in a tax reduction. Hence, to that extent the recovery of the property against which such liabilities were offset or compensation therefor would not result in realization of income or gain in the year or years of such recovery.

Section 127(c) is based upon the general principle that the recovery of property deemed to have been destroyed or seized or of compensation or indemnity therefor results in realization of gain not to exceed the fair market value of the property when recovered or the amount of such compensation or indemnity, but the amount of income realized shall not in general exceed the amount of war loss deductions in prior years which operated to reduce any income tax liability of the taxpayer in a prior year or years. This is the so-called tax benefit rule. As will appear, how-

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to most taxpayers, since it is by no means certain that Dec. 7, 1941 value, if determinable at all, would in the majority of cases have exceeded the adjusted basis of the assets.

[21] *Supra* note 6.

[22] Reg. 103, §19.127(b)-1 contains detailed provisions relating to and illustrating the meaning and application of this subsection. Space does not permit a full analysis here.

ever, there is one important departure in Subsection (c) from a strict adherence to the rule. The operation of the section can best be illustrated by a concrete example. Assume that corporation *X* owned a plant in Germany, the adjusted basis of which, on the date war was declared, was $1,000,000. It also owned stock in an Italian company, all of whose assets were in Italy, with an adjusted basis of $500,000 and a fair market value of $750,000 on the date of the declaration of war. Corporation *X* claimed and was allowed a deduction of $1,500,000 in its return for the taxable year 1941, such return showing a net loss of $500,000. The corporation had losses on its returns for 1942 and 1943, before any deduction of the net operating loss for 1941 under Section 122. Let us further assume that in 1946, *X* recovers its German plant intact, and that such plant has a fair market value in that year of $900,000. *X* realizes gain reportable in its 1946 return in the amount of $400,000, representing the excess of the value of the recovery over the portion of the 1941 deduction, *i.e.*, $500,000, from which *X* derived no tax benefit. Furthermore, the gain so realized in 1946 is taxable as ordinary income.

Let us further assume that the taxpayer in its taxable year 1948 procures compensation of $650,000 for the loss of its stock in the Italian company. The entire amount recovered in that year constitutes gain under Section 127(c). The gain to the extent of $600,000 will be subject to tax as ordinary income at full rates. But the remaining increment of $50,000 is treated as a gain upon involuntary conversion. Whether or not such gain is recognized will be governed by Section 112(f) of the Code. To the extent such gain is recognized, it will be subject to tax under the provisions of Section 117(j).

The taxation of such an increment as a gain upon involuntary conversion will probably be one of the features of Section 127 which will be criticised on grounds of policy. The interests of the revenue would have been adequately protected by taxing as ordinary income the value of recoupments or recoveries only to the extent justified by the tax-benefit principle, with the basis of the recovered assets adjusted accordingly. On the other hand, the rule of Section 127(c) is not easy to criticise on purely logical grounds. Section 127 as a whole is based upon the concept of treating war losses as losses due to destruction or seizure. Such losses are now classified by Section 117(j) as losses due to involuntary conversion. Section 127(c) merely treats such loss or destruction as itself a closed transaction and works out the future tax consequences accordingly. From a practical point of view, the matter does not seem to be of great importance, since it does not now seem probable that the value of recoupments or recoveries in a great majority of instances will be sufficient to bring this rule into operation. The valuation of recoveries in kind may well produce many difficult problems, but these seem unavoidable, if the revenue is to be given a fair measure of protection.[23]

[23] Section 127(d) contains specific rules to govern the determination of the basis of recovered property, but space does not permit an analysis of this subsection in the present article.

Section 127(e) is important and is of unusual interest because it introduces into the income tax law for the first time the concept of a deduction—strictly limited, it is true—based upon the partial worthlessness of stock. The need for such a limited allowance, however, is clear. In many cases, virtually all the operating assets of a foreign subsidiary may have been in enemy territory, but it might have had intangibles, such as bank accounts in friendly countries, or accounts receivable from non-enemy nationals, sufficient in amount to leave some increment of value in the subsidiary's stock or securities. Hence, Section 127(a)(3) would not be applicable and would give no relief. Yet the loss of value in the stock or securities would in all probability be permanent, because of the catastrophic character of the subsidiary's loss. Filing a consolidated return would not help since foreign corporations cannot be included in a consolidation, and also in many of these cases the requisite 95% stock ownership would not be present, although a simple control test could be satisfied.

Section 127(e) meets this problem in a rather ingenious way. In the first place, it applies only if the taxpayer owns not less than 50% of each class of the stock of the subsidiary corporation. In the second place, assets of the corporation, the adjusted basis of which constitutes at least 75% of the adjusted basis of all the assets, must be property deemed to be destroyed or seized under Subsection 127(a)(1) or (2), but in the determination of such percentage certain kinds of assets specified in Section 127(e)(2)(A) are excluded, such as bank deposits in friendly countries, accounts receivable from non-enemy nationals, and obligations issued or guaranteed by the United States. In other words, the assets included are chiefly the operating properties.

If these basic conditions are satisfied, and if within one year after such property is deemed to be destroyed or seized or within six months after the date of enactment of the 1942 Act, such subsidiary corporation is liquidated, then that portion of the loss on such liquidation which would be attributable to such destruction or seizure, as established to the satisfaction of the Commissioner, is deductible under Section 127(a)(3). Such loss on liquidation is not limited to loss on capital stock but applies to other interests of the taxpayer in the corporation, such as bonds or other securities or open accounts. Losses under Section 127(e) are not necessarily realized in the year war was declared or in the year the property passed under enemy control, but rather in the year the liquidation is consummated. This is the more reasonable interpretation of the statute and is the rule stated in the regulations.[24] It is clear, however, that the capital stock of the subsidiary may become a loss under Section 127(a)(3), while Section 127(e) must be satisfied to get a war loss deduction on the bonds. This would be the case where the value of the assets not deemed to be destroyed or seized would, in the event of liquidation, be insufficient to yield anything for the stock, *i.e.*, the stock has become worthless.

[24] See Reg. 103, §19.127(e)-1.

There is a good administrative reason for the requirement of a liquidation as a condition to relief under Section 127(e). The effect of liquidation is to vest ownership of the properties deemed to be seized or destroyed, or the right to recover the same or indemnity therefor, in the taxpayer and other shareholders. If such properties are later recovered in kind or compensation received, the Government is more likely to collect any tax resulting therefrom under Section 127(c)(2) than if it were required to rely solely on Section 127(c)(3), which in certain cases treats restoration of the value of investments deemed to be seized or destroyed as a recovery. But a rigid enforcement of the liquidation requirement would have nullified the application of Section 127(e) in many cases for the practical reason that a liquidation of a foreign subsidiary which is technically valid under the applicable foreign law is frequently impossible under war conditions. The Treasury has recognized these practical difficulties and has stated in the regulations that Section 127(e) will not be denied application because of technical flaws in the liquidation, if the taxpayer has in good faith complied as fully as possible with the requirements of the applicable laws and if the taxpayer executes a statement of its determination to treat such liquidation as valid for all purposes, including the treatment of any recoveries with respect to assets or right to assets distributed to it in a manner consistent with Section 17(c) and files any waivers of the statute of limitations which may be necessary in order to protect the Government should the taxpayer subsequently contend the liquidation was invalid.[25]

In conclusion, there can be little doubt that, despite any imperfections it may have, Section 127 and related provisions represented a reasonable and bona fide effort to treat the losses of foreign property and investments of American taxpayers, caused by the catastrophe of war, in a fair and equitable manner. There can be even less doubt that it will produce much fairer results in a vast majority of cases, with less uncertainty and litigation, than would have been possible under the preexisting law.[26]

[25] See Reg. 103, §19.127(e)-1(a)(3). This provision is a fair and practical one. Of more doubtful reasonableness, though probably technically valid, is a method of allocation prescribed by §19.127(e)-1(b), which operates to limit the war loss deduction to that part of the loss of value of the stock or securities which is in fact attributable to the particular assets, included in the computation of the percentage, which are deemed to have been destroyed or seized. Since the requisite percentage under §127(e) is so high, the complications in administration arising out of this formula seem to outweigh the benefit to the revenue of this refinement, however justified in theory it may be.

[26] The question may be asked whether §127 is mandatory in the sense that the taxpayer must claim its benefits. Suppose a taxpayer has foreign property or investments but, because they all have a very low basis or because the taxpayer is confident of their recovery intact after the war, no deduction whatever for war losses is claimed on their account in the taxpayers returns. It is clear that §127 does not treat their recovery in such a case as a transaction productive of income or gain on involuntary conversion. There has been no tax benefit whatever in such a case, and §127 does not operate automatically to reduce the basis of such property or investments to zero. Section 127(c) only functions if the taxpayer has taken some war loss deductions. But the taxpayer cannot pick and choose, *i.e.*, claim deductions on items of property with a high basis and omit items wtih a low basis. If such an attempt is made, §127 will be applicable in the regular way to all recoveries, although the failure to include certain items in the war loss deduction may limit the amount of deduction resulting in a tax benefit.